Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

INFORMATION SYSTEMS & NETWORKS CORPORATION,
PETITIONER

v.

UNITED STATES

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Does the decision below denying petitioner the right to be reimbursed for the state income taxes it paid as a result of performing its contract with the government subvert the purposes of the Federal Acquisition Regulations, the Small Business Act, public policy and Congress' intent that government not penalize through its reimbursement scheme those who elect to organize themselves as a Subchapter S corporation?

2. Does the decision below run afoul of the policies of Congress and the Executive Branch which foster the robust participation of small businesses generally and Subchapter S corporations in particular in the Nation's commerce, including the federal government's procurement of goods and services from vendors such as the petitioner?

3. Is the constitutional guaranty of the equal protection of the laws undermined by the decision below which applies the Federal Acquisition Regulations differently for no reason rooted in law to those like the petitioner who as a small business elects to organize itself as a Subchapter S corporation?

RULE 29.6

Petitioner is a privately held corporation and no publicly held company owns more than 10% of Petitioner's stock.

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OPINIONS BELOW

The published opinion of the United States Court of Appeals for the Federal Circuit in *Information Systems & Networks Corporation v. United States* (C.A. Nos. 04-5151 and 5154),437 F.3d 1173, U.S. App. LEXIS 2820(Fed. Cir. 2006), decided February 6, 2006, reversing the United States Court of Federal Claims which allowed the petitioner to recover as part of its costs under its reimbursement contract with the respondent United States the state income tax payments its sole shareholder paid as part of the business activities related to this contract, is set forth in the Appendix hereto(App. 1-10).

The published opinion of the United States Court of Federal Claims in *Information Systems & Networks Corporation v. United States*(Docket No. 98-663C), 48 Fed. Cl. 265(2000), decided November 30, 2000, allowing the petitioner to recover as part of its costs under its reimbursement contract with the respondent United States the state income tax payments its sole shareholder paid as part of the business activities related to this contract, is set forth in the Appendix hereto(App. 11-30).

The unpublished order of the United States Court of Appeals for the Federal Circuit in *Information Systems & Networks Corporation v. United States* (C.A. Nos. 04-5151 and 04-5154), decided and filed April 14, 2006, denying the petitioner's timely filed combined petition for panel rehearing or for rehearing *en banc*, is set forth in the Appendix hereto(App. 31-32).

JURISDICTION

The decision of the United States Court of Appeals for the Federal Circuit reversing the Court of Federal Claims' decision allowing the petitioner to recover its state tax payments as part of the reimbursable costs under this contract with the United States, was entered on February 6, 2006; its further order denying the petitioner's timely filed combined petition for panel rehearing or for rehearing *en banc* was filed and decided on April 14, 2006; on July 3, 2006, the petitioner timely applied to The Chief Justice of this Court for an extension of time to file its petition for certiorari (Docket No. 06A25); and on July 11, 2006, The Chief Justice granted the petitioner's motion, extending the time to file its petition for certiorari until August 14, 2006(App.1;31).

This petition for writ of certiorari is filed within the time limits prescribed by the Chief Justice in Docket No. 06A25, allowing the petitioner's application for an extension of time to file this petition.

The jurisdiction of this Court is invoked pursuant to the provisions of 28 U.S.C. Section 1254(1).

RELEVANT PROVISIONS INVOLVED (see appendix)

STATEMENT

The petitioner Information Systems & Networks Corporation ("the petitioner" or "ISN") is a corporation duly organized under Subchapter S of the Internal Revenue Code, 26 U.S.C. Sections 1361-1379. Such so-called "S corporations" are small businesses in

corporate form which have fewer than 75 employees, 26 U.S.C. Section 1361(b)(1)(A), and often have a sole shareholder. In fact, during the years 1985 through 2000, INS' sole shareholder was Ms. Roma Malkani.

In electing to proceed in business as an S corporation, INS was taking advantage of the "tax neutral" provisions which attend such corporate status. As Congress provided, when a small business such as INS decided to incorporate as an S corporation, it incurred the same tax liability on its income whether the business incorporated or not. Subchapter S accomplishes this by eliminating the "double taxation" that usually attends corporate income from a normal or "C" corporation . See 26 U.S.C. Section 1363. With "C" corporations, the corporate entity must pay income taxes on its own income and then when it distributes after-tax income to its shareholders, those shareholders must also pay personal income tax on that source of income, a "double taxation."

With S corporations, however, Congress has provided that no income tax accrues to the corporation; instead, the corporation's income is "passed through" to the shareholders and is attributed to the shareholders' personal income tax liability in pro rata amounts. 26 U.S.C. Section 1366. Most States have taken advantage of the option of recognizing the federal S designation by aligning their own tax codes with the federal Internal Revenue Code in order to acknowledge and allow this "pass through" of income tax liability from the corporation to the shareholder(s), taxing only the shareholder(s) for their personal income tax liability in pro rata amounts.

In the 1980's and early 1990's, the petitioner and the respondent United States ("the respondent" or "the government") entered into several cost-reimbursement contracts. As explained in 48 CFR Section 16.301-1, where the cost cannot readily be ascertained at the time of contracting, these types of contracts between the federal government and a private contractor provide a cost ceiling for the work to be performed and permit the government to pay up to that ceiling amount for allowable incurred costs of the contractor for the contract work.48 CFR Section 16.301-2.

During its performance of a cost-reimbursement contract, the contractor incurs direct costs in the form of material, labor, equipment, etc. and indirect costs such as taxes, rental space, insurance, etc. Generally, both direct and indirect costs generated by the contract's performance are allowable if they are reasonable, allocable to the contractor's performance of the contract, founded on generally accepted accounting principles, within the terms of the contract and not otherwise prohibited. 48 CFR Section 31.201-1 and 2. Once performance is complete, a contractor is paid for its indirect costs by requesting reimbursement for them via an "indirect rate proposal." The proposal requests that these costs be included in a so-called "rate pool." The government audits the proposals, determining whether the costs stated by the contractor are allowable within the terms of 48 CFR Section 31.201-1 and 2, and ultimately pays the contractor for its allowable costs according to the rates established by the contract.

The dispute giving rise to this controversy began when the petitioner submitted indirect rate

proposals for FYs 1985 through 1991, proposals which included a request for reimbursement of state income taxes paid for each of those years within its general and administrative expense rate pool. In support of its request for reimbursement of the state taxes it had paid, INS asserted that the Federal Acquisition Regulations, especially 48 CFR Section 31.205-41(a)(1), intended to include such tax reimbursement within its framework; that there was a valid, binding agreement between INS and its sole shareholder, Ms. Malkani, which obligated INS to reimburse her for the state income taxes she paid (to the State of Maryland) as a result of the "pass through" nature of the income earned by this S corporation, thereby creating a valid, reasonable cost to INS in the performance of its contract with the government; and that other S corporations had been reimbursed for state income taxes in this manner.

All of the state income taxes for which the petitioner has sought reimbursement fron the government were imposed in States which acknowledge and allow this "pass through" of income tax liability from the corporation to the shareholder(s), taxing only the shareholder(s) for their personal income tax liability in pro rata amounts, as under the Internal Revenue Code. The petitioner subsequently submitted rate proposals, including requests for state income tax payments, for each fiscal year up to and including 2000.

Except for one year, the government's audit agency (the Defense Contract Audit Agency or "DCAA"), which processed the petitioner's proposals, denied INS' claims for reimbursement of the state income taxes it paid for these years as unallowable.

DCAA based its decision on the fact that INS was an S corporation and therefore was not subject to state income tax:

> The contractor is a Sub-Chapter S Corporation. As such, with few exceptions, the corporation is not taxed by the state on its income; rather the income flows to the stockholders who pay tax on their personal income tax returns. Thus, this is a personal tax expense to the shareholders. The state income taxes of individuals are not allocable to the company, as described in [48 CFR Section] 31.201-4, determining allocability, and therefore are not part of the contract costs, directly or indirectly.

(App. 15).

This dispute continued until April 16, 1998, when the government's Contracting Officer denied INS' claims for the reimbursement of the state income taxes it paid and ordered the petitioner to repay the government for earlier reimbursements it deemed unallowable costs.

On August 18, 1998, the petitioner appealed the Contracting Officer's decision to the United States Court of Federal Claims pursuant to the provisions of the Contract Disputes Act of 1978, 41 U.S.C. Section 609(a)(1). It asked the court to declare that when Ms. Malkani paid state income taxes on its behalf as the sole shareholder of this S corporation, it was a reimbursable, allowable cost under the Federal Acquisition Regulations and therefore should have been included in its indirect rate cost pool for all the contracts

performed by the petitioner for the government. The government counterclaimed asking for the return of its previous reimbursements of a portion of the state income taxes paid by INS.

Upon cross motions for summary judgment, the Court of Federal Claims, Futey, J., first reviewed all of the pertinent provisions of the Federal Acquisition Regulations, especially 48 CFR Section 31.205-41, addressing whether the payment of taxes could be allowable costs entitled to reimbursement in this context(App. 18-19). As the motion judge concluded, those provisions of the Federal Acquisition Regulations specifically addressing how the payment of taxes should be considered for purpose of determining whether such tax payments are "costs" to be reimbursed unmistakably provide that certain Federal, state and local taxes are allowable if they are "are required to be and are paid or accrued in accordance with generally accepted accounting principle" but that if the contractor "is exempt from a certain tax liability...and still proceeds to pay such tax, that tax expenditure is not allowable"(App. 19 citing 48 CFR Section 31.205-41(a) and (b)(3)).

The petitioner argued that Subpart 31.2 of the Federal Acquisition Regulations by its own terms applies to all "commercial organizations," including Subchapter S Corporations, and there are no provisions justifying different treatment of this entity in determining whether state taxes are allowable costs(App. 19). Moreover, it contended that Ms. Malkani had to pay the state a personal income tax as a result of this corporate income; that it was required by agreement to reimburse Ms. Malkani, its sole

shareholder, for this expense; and that such expense was reasonable and allocable because "it was necessary to maintain its [corporate] charter [in the State] and therefore its ability to continue performing work on its contracts with the government"(App. 19-20). The government argued that since INS did not have to pay state income tax in the first instance, its claims for reimbursement are neither allowable under 48 CFR Section 31.205-41(a) and (b)(3), nor reasonable or allocable under the general provisions regulating reimbursement(App. 20).

Judge Futey, however, reasoned that the petitioner's payment of State taxes even though made in the form of reimbursing Ms. Malkani for the State personal income tax she was compelled to pay on account of this corporate income, was an allowable and therefore reimbursable cost. As he saw it, although INS is technically "exempt" from paying state income taxes on its corporate income because of its S corporation status, it is *not* an exemption in the ordinary sense of that term, i.e., the complete absence of a duty to pay taxes such as when a tax abatement occurs(App. 21-22;28-29). Instead, the petitioner is relieved of paying State income tax only because its duty to do so *has not been extinguished but merely transferred* to another entity, its sole shareholder Ms. Malkani, as a result of the "pass through" provisions which characterizes this corporate form as mandated by Congress(App. 21-22). Thus the motion judge concluded that the petitioner, "as an S corporation, is not relieved of state tax liability, but is simply required to pass its liability on its corporate income to Ms. Malkani"(App. 22).

As the motion judge concluded, nothing in the Federal Acquisition Regulations requires that any specific part of a corporation pay the applicable State income taxes(App. 22). Instead, it clearly provides that State taxes which are required to be paid and are paid constitute allowable costs; and because the State taxes here were required to be paid and were paid and "because the tax liability on the corporate income was not subject to abatement or reduction, the state income taxes claimed by the [petitioner] for reimbursement are allowed under the Taxes Provision [of the Federal Acquisition Regulations]"(App. 22).

In a footnote, Judge Futey reasoned that the language forbidding reimbursement when the contractor is "exempt" from the state tax was intended to avoid a "double recovery" by a contractor who is reimbursed by the government for taxes it erroneously paid but does not owe and thereafter receives a refund of the tax from the taxing authorities resulting in a double recovery(App. 29). However, as he noted, there is no danger of a double recovery here because "no refund is available from the state tax authority...[and] the taxes were not erroneously or mistakenly paid but were in fact required to be paid"(App. 29).

In addition, the lower court thought that its interpretation of the Federal Acquisition Regulations to find that the taxes here were allowable costs comports with their general intent not to deny reimbursement to business entities simply because of their tax election or corporate structure(App. 22). Nor does any language in the Internal Revenue Code support the proposition that an election to do business as a Subchapter S corporation with the characteristic of

pass-through taxation will cause it to lose out on reimbursement due to its tax election(App. 22). As it observed, neither the Federal Acquisition Regulations nor Subchapter S of the Internal Revenue Code state that an S corporation is only allowed one type of tax relief, either pass-through taxation or cost-reimbursement(App. 22). As it noted,

> S corporations are small businesses and their corporate structure is meant to help, not hinder, the growth and health of these businesses. It is the general intent of the [Federal Acquisition Regulations] to aid and encourage small businesses as well. [Moreover,] if the Taxes Provision does not allow reimbursement for state income taxes for S corporations, such corporations will most likely change their tax election to C corporation status in order to benefit from the cost reimbursement available from the Taxes Provision. This change in election would cause these government contractors to be taxed at the higher C corporation rates, and therefore the amount the federal government will be required to reimburse will be higher as a result.

(App. 12;29-30). Especially where the S corporation has reimbursed its sole shareholder for the state tax payments which it incurred and which she made on its behalf and where other S corporations previously have been reimbursed for such payments, the government "is obligated to reimburse [ISN] for this transferred pass-through tax expenditure"(App. 23).

Finally, Judge Futey rejected the idea

propounded by the government that the two tax liabilities associated with an S corporation's pass-through income are separate and distinct and that ISN has no basis for requesting reimbursement for the tax expenditures of Ms. Malkani(App. 23-25). His review of the tax codes of the relevant States showed that the relationship between an S corporation and its shareholders is an intermingled, intertwined one for state tax purposes, i.e., *both* the S corporation and its shareholders are "very much" obligated to ensure that state income taxes generated by corporate business are paid(App. 25).

The lower court therefore granted the petitioner's motion for summary judgment, denied the government's cross motion for the same relief and ruled as a matter of law that the Taxes Provision of the Federal Acquisition Regulations (48 CFR Section 31.205-41) allows an S corporation to be reimbursed for the costs associated with the payment of state income tax taxes incurred on its corporate income in the course of performing its cost-reimbursement contract with the government (App. 25). In a ruling of July 21, 2004, Judge Futey determined after a trial that the petitioner was entitled to reimbursement from the government for the applicable years between 1985 and 2000 in the amount of $1,133,176.00.

The government appealed summary judgment ruling to the court of appeals for the federal circuit and on February 6, 2006, the court, in an opinion by Frost, J., reversed Judge Futey, ruling that he had improperly interpreted the Taxes Provision of the Federal Acquisition Regulations, 48 CFR Section 31.205-41(App. 1-10). According to the court of appeals, while

the language of the Taxes Provision makes clear that the term "exemption" means freedom from taxation in whole or in part and may include a tax abatement or reduction, there is no support in the Federal Acquisition Regulations for the conclusion that tax abatements or reductions represent the exhaustive list of exempt taxes(App. 7).

In addition, the court appeals ruled that Judge Futey had erred by supposing that since state income taxes were required to be paid and were paid here, that allowability of this cost inevitably follows under the Federal Acquisition Regulations(App. 7-8). As it ruled,

> the allowable taxes described in 48 CFR Section 31.205-41(a) apply to taxes paid by the contracting party. As an S corporation, ISN never paid any state income taxes. Only Ms. Malkani paid state income taxes on *dividends* paid to her from ISN. Because she is not the contracting party, 48 CFR Section 31.205-41 is inapplicable to Ms. Malkani's state income tax payments. The Court of Federal Claims incorrectly concluded that, because the state income tax liability was not a tax reduction nor an abatement, the state income tax liability could not be an exempt tax under 48 CFR 31.205-41(b).... [But this provision provides] that taxes from which the contracting entity is exempt are not allowable costs. This is the case here. ISN is free from taxation on Ms. Malkani's income derived from ISN's corporate *dividends*. Therefore, in its cost-reimbursement contract, Ms. Malkani's state income tax payments themselves cannot be an allowable cost for ISN.

(App. 7-8;9)(emphasis supplied).

Because the Court of Federal Claims had improperly interpreted 48 CFR 31.205-41(b)'s language about "exemptions" too narrowly and had improperly concluded that Ms. Malkani's state income tax payments ere allowable costs, it reversed the ruling below and remanded the case to that court for further proceedings consistent with that opinion(App. 9-10).

On April 14, 2006, the court of appeals denied the petitioner's timely filed combined petition for panel rehearing or for rehearing *en banc*(App. 31-32). On July 11, 2006, The Chief Justice granted the petitioner's timely filed motion seeking an extension of time to file its petition for certiorari until August 14, 2006.

REASONS FOR GRANTING THE PETITION

1. Denying A Subchapter S Corporation Recovery As Part Of Its Allowable Costs Under Its Reimbursement Contract With The Respondent The Income Taxes Its Sole Shareholder Paid To The State Undermines The Purposes Of The Federal Acquisition Regulations, the Small Business Act, Public Policy and Congress' Intent That The Federal Government Not Use The Reimbursement Scheme To Penalize Those Who Organize Themselves In Business As A Subchapter S Corporation.

The gist of the court of appeals' ruling below is that even though there was an agreement in place between ISN and its sole shareholder, Ms. Malkani, for ISN to reimburse her for any state income tax she was

compelled to pay as the result of ISN's corporate income "passed through" to her on account of its Subchapter S status, it was nevertheless a tax liability founded upon Ms. Malkani's "income derived from ISN's corporate *dividends.*" (App. 7-8)(emphasis supplied). As such, it was a tax liability separate and distinct from ISN which was the contracting party with the government and which is exempt or free from taxation(App.7-9). Thus the court of appeals ruled without citation to any decisional law that Ms. Malkani's state income tax payments themselves cannot be an allowable cost for ISN(App. 9).

This ruling misapprehends the true nature of S corporations as contemplated by Congress when it authorized in the Internal Revenue Code these hybrid corporate structures for use by small businesses in order to avoid the "double taxation" incident to the formation of traditional C corporations. It also misconstrues relevant portions of the Federal Acquisition Regulations in a way that makes every S corporation "exempt" from paying taxes and therefore ineligible for reimbursement for the taxes it actually does pay as a cost of doing business under the government's procurement programs.

More important, this result by the court of appeals undercuts completely Congress' expressed intent in establishing Subchapter S status in the Internal Revenue Code and enacting the Small Business Act (16 U.S.C. Section 631 *et seq.*) of encouraging small businesses such as INS to engage robustly in the Nation's commerce, including the federal government's procurement of goods and services, on the same footing as traditional C

corporations. In fact, the court of appeals' decision serves as a rationale to *penalize* those who organize themselves in business as an S corporation by denying them reimbursement for the state taxes they do pay as a cost of doing business with the government, thereby encouraging these entities to reform themselves as traditional C corporations who will eventually seek and obtain *even larger* reimbursements from the government for the state taxes they pay incident to their cost-reimbursement contracts.

In the first place, in establishing S corporation status in the Internal Revenue Code, Congress provided that while the S corporation itself would not be subject to taxes "imposed by this chapter," corporate income for tax purposes would "pass thru" or be transferred to the corporation's shareholder(s) on a pro rata basis. 26 U.S.C. Sections 1363(a); 1366(a)(1). As Congress provided,

> the character of any item included in a shareholder's pro share...shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

26 U.S.C. Section 1366(b).

That is, the S corporation organizational form serves as a conduit for the taxable income of the corporation to flow from the corporate level to the shareholder(s) for purposes of reporting this corporate income on the shareholder's personal income tax return. In this way, the corporation's income and

expenses are "passed through" and taxed to the shareholder(s) at the corporation's year end, regardless of whether the shareholder(s) ever actually receive this corporate income. 26 U.S.C. Sections 1367(a);1368. The essence of the arrangement is *the transfer* of the S corporation's tax liability on its income to the corporation's shareholders on a pro rata basis.

After all, Congress was acknowledging the fact that a small business' decision to incorporate under Subchapter S of the Internal Revenue Code, i.e., to carry on its business in corporate form but without invoking the "double taxation" applied to traditional C corporations, was bottomed on its desire to do business like a partnership but in corporate form without incurring unnecessary tax penalties. See *Klein v. Comm.*, 75 TC 298, 302-303(1980). Indeed, when Congress enacted The Subchapter S Revision Act of 1982, it intended to minimize further the effect of income taxes on the decision to form a business organization by continuing to enable small businesses to have the benefits of incorporation as an S corporation without the incidence of income at both the corporate and shareholder level. See S. Rep. No. 640, 97th Cong., 2d Sess. 5, *reprinted in* 1982 U.S. Cong. & Adm. N. 3253-57.

Judge Futey appreciated this unique taxation scheme by finding that the relationship between an S corporation and its shareholder(s) for tax purposes could not be characterized simply as separate and distinct but rather was a hybrid one which was intermingled and intertwined, i.e., whether a shareholder pays state income tax on corporate income with the corporation reimbursing her or whether the S

corporation itself pays the income tax directly to the state, the S corporation----*not* the shareholder----is subject to potential penalty and/or encumbrance of its ability to do business within that state in the event this tax is not paid by either the corporation or the shareholder.

As the Court of Federal Claims explained, in order to enforce the payment of state income taxes owed by nonresident shareholders, many states require *the S corporation itself* to pay such taxes on behalf of the shareholder(s) either in the form of a corporate-level tax or in the form of a withholding tax. See, e.g., Idaho Code, Section 63.3022(k); La. Rev. Stat. Ann., Section 47:287.732; Okla. Stat., Section 2365; Utah Code Ann., Section 59-7-105(3)(c);Vt. Stat. Ann., Sections 5811 (18), 5823(a); W.Va. Code, Section 11-21-71a(b), (h); Wis. Stat., Sections 71.33, 71.36. These statutorily mandated requirements for an S corporation to conduct business in a particular State confirm Judge Futey's analysis that the S corporation's state tax obligation *begins with the S corporation itself* and is thereafter intermingled and intertwined with its shareholder(s).

It is *not* simply the shareholder's obligation alone to pay the S corporations's state taxes and the court of appeals was wrong to conclude otherwise. Once the true dimensions of the "pass through" nature of the S corporation's income tax liability are acknowledged and ISN's inability to conduct business in a state if its taxes are not paid are recognized, as the Court of Federal Claims did here, it becomes clear that Ms. Malkani's payment of the state tax payments—coupled with ISN's agreement to reimburse her for those state

tax payments—are reasonable, allocable and therefore allowable within the meaning of 48 CFR Sections 31.201-2 *et seq.*

Second, the decision of the court of appeals ignores the plain language of the Federal Acquisition Regulations in a way that makes every S corporation "exempt" from paying taxes and therefore ineligible for reimbursement for the taxes it actually does pay as a cost of doing business under the government's procurement programs. As an initial matter, there is absolutely no support on this record for the court of appeals' surmise that Ms. Malkani was somehow receiving corporate *dividends* for which she was paying state income taxes(App. 7-8;9). Instead, ISN's *corporate income* was being transferred and therefore attributed to Ms. Malkani via the "pass through" provisions of 26 U.S.C. Sections 1366(a) and (b), as mandated by Congress. This revenue generated by ISN under its cost-reimbursement contract with the government is *not* a dividend and the court of appeals' decision to characterize it as such bespeaks a confusion on its part about the true nature of this arrangement for tax purposes and undermines the decision it reached in this matter.

Nor did the court of appeals apply the appropriate standard for construing the term "exemption" in 48 CFR Section 31.205-41(b)(3), to include the "pass through" tax payment arrangement here between ISN and its sole shareholder Ms. Malkani. Just because ISN can "pass through" its income to its sole shareholder Ms. Malkani for income tax purposes under the Internal Revenue Code does not mean that it is "free from taxation" in the sense

that it is "exempt" from tax liability within the meaning of 48 CFR 31.205-41(b)(3). As Judge Futey cogently observed, as an S corporation, ISN "is not relieved of state tax liability [by this arrangement], but is simply required to pass its liability on its corporate income to Ms. Malkani"(App. 22).

This construction of 48 CFR Section 31.205-41(b)(3) by Judge Futey which makes ISN's claim for reimbursement of its state income tax payments allowable under the Federal Acquisition Regulations is correct as a matter of law. The starting point for this regulatory interpretation is the language of the regulations themselves. *Duncan v. Walker*, 533 U.S. 167, 172(2001). *Williams v. Taylor*, 529 U.S. 420, 431(2000). When that regulatory language speaks with clarity, "judicial inquiry into the [regulation's] meaning, in all but the most extraordinary circumstances, is ended." *Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 475(1992). See *Robinson v. Shell Oil Co.*, 519 U.S. 337, 340(1997); *Walters v. Metropolitan Ed. Enterprises, Inc.*, 519 U.S. 202, 209(1997).

Moreover, where the plain meaning of a tax regulation cannot be ascertained with sufficient certainty, "the doubt must be resolved *against* the government and *in favor* of the taxpayer." *United States v. Merriam*, 263 U.S. 179, 188(1923)(emphasis supplied). See also *Hassett v. Welch*, 303 U.S. 314(1938). This rule of statutory construction is complemented by the principle that remedial regulations such as 48 CFR Section 31.205-41(b)(3), should be interpreted broadly in order to effectuate obvious Congressional goals. *Northeast Marine Terminal Co. v. Caputo*, 432 U.S. 249, 268(1977). The resulting interpretation should be

one consistent with the taxing statutes viewed as an organic whole. *Brown v. Gardner*, 513 U.S. 115, 118(1994).

Applying these principles of construction, the term "exemption" in 48 CFR Section 31.205-41(b)(3), is strictly construed. *Vill. of Shaumburg v. Citizens for a Better Env't.*, 444 U.S. 620, 644 n. 2(1980). According to 48 CFR Section 31.205-41(b)(3), it means "freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise." However, as Judge Futey found, there was no such "exemption" here.

He found that although INS is technically "exempt" from paying state income taxes on its corporate income because of its S corporation status, it is *not* an exemption in the ordinary sense of that term, i.e., the complete absence of a duty to pay taxes such as when a tax abatement occurs(App. 21-22;28-29). Instead, applying this Court's decisional law that it will look to substance over form in a tax transaction, *Frank Lyon Co. v. United States*, 435 U.S. 561, 573(1978), Judge Futey ruled that INS was relieved of paying state income taxes only because its duty to do so *had not been extinguished but merely transferred* to another entity, its sole shareholder Ms. Malkani, as a result of the "pass through" provisions which characterize this corporate form of small business, as mandated by Congress(App. 21-22). Thus he concluded that INS, "as an S corporation, is not relieved of state tax liability, but is simply required to pass its liability on its corporate income to Ms. Malkani"(App. 22).

As the motion judge ruled, nothing in the Federal Acquisition Regulations requires that any specific part of a corporation pay the applicable state income taxes(App. 22). Instead, it provides that state income taxes which are required to be paid and are paid constitute allowable costs; and because the state taxes here were required to be paid and were paid and "because the tax liability on the corporate income was not subject to abatement or reduction, the state income taxes claimed by the [petitioner] for reimbursement are allowed under the Taxes Provision [of the Federal Acquisition Regulations]"(App. 22). Judge Futey further reasoned that the language forbidding reimbursement when the contractor is "exempt" from the state tax was intended to avoid a "double recovery" by a contractor who is reimbursed by the government for taxes it erroneously paid but does not owe and thereafter receives a refund of the tax from the taxing authorities resulting in a double recovery(App. 29). However, as he noted, there is no danger of a double recovery here because "no refund is available from the state tax authority...[and] the taxes were not erroneously or mistakenly paid but were in fact required to be paid"(App. 29).

Third, the result below undercuts Congress' expressed intent in enacting the Small Business Act, 16 U.S.C. Section 631 *et seq.* The Act encourages small businesses such as INS to engage robustly in the Nation's commerce, including the federal government's procurement of goods and services, on the same footing as traditional C corporations. As Congress found incident to the Act's passage, it was intended to foster "business ownership and development by individuals in groups that own and control little productive

capital..."15 U.S.C. Section 631(d)(2)(B)(I). In addition, Congress has declared that

> it is the continuing policy and responsibility of the Federal Government to use all practical means and to take such actions as are necessary, consistent with its needs and obligations and other essential considerations of national policy, to implement and coordinate all Federal department, agency, and instrumentality policies, programs, and activities in order to: foster the economic interests of small businesses....

15 U.S.C. Section 631a(a). None of these interests is served by affirming the court of appeals' reasoning below.

2. As A Matter Of Equal Protection Of The Laws, This Court Should Rule That The Petitioner, A Subchapter S Corporation, Should Be Allowed Like Any C Corporation To Recover From The Respondent United States As Part Of Its Allowable Costs Under Its Reimbursement Contract The State Income Taxes It Paid.

There is no question on this record that a C corporation would be entitled to reimbursement from the government for the state taxes it paid incident to its performance of a cost-reimbursement contract. That a Subchapter S corporation receives lesser treatment, that pursuant to the decision below it is not entitled to reimbursement for the state taxes it paid, amounts to the kind of disparate, unfair and unequal treatment which bespeaks a denial of the equal protection of the

laws under the fifth amendment to the Federal Constitution. *Allegheny Pittsburgh Coal v. Webster County*, 488 U.S. 336, 343-344(1989). *Kahn v. Shevin*, 416 U.S.351, 355(1974). *Johnson v. Robison*, 415 U.S. 361, 374-375(1974). See *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 547(1983); *Carmichael v. Southern Coal Co.*, 301 U.S. 495, 509-510(1937).

While ISN does not face the prospect of double taxation, it nevertheless faces the severely adverse consequence that its state tax liability will be unreimbursed by the government as a result of its election to organize itself as an S corporation. It therefore will have a higher cost of doing business than that of a C corporation in the same circumstances on account of its unallowable, unreimbursed state tax payments. This result, different from that of a C corporation in similar circumstances, is bottomed on no rule of law and constitutes a denial of the equal protection of the laws under the fifth amendment.

As a matter of the equal protection of the laws, then, this Court should rule that the petitioner, a Subchapter S corporation, should be allowed like any C corporation to recover from the government as part of its allowable costs under its cost-reimbursement contract the state income taxes it paid as a cost of doing business with the government.

CONCLUSION

For all of these reasons identified herein, a writ of certiorari should issue to review the judgment of the United States Court of Appeals for the Federal Circuit and, ultimately, to vacate that judgment and remand the matter to the United States Court of Federal Claims with instructions that it reinstate its decision allowing the petitioner to recover as part of its costs under its reimbursement contract with the respondent United States the state income tax payments its sole shareholder paid as part of the business activities related to the contract; or provide the petitioner with such other relief as is fair and just in the circumstances of this case.

Respectfully submitted,
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(any footnotes trail end of each document)
04-5151, 04-5154
UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

INFORMATION SYSTEMS & NETWORKS CORPORATION,
Plaintiff-Cross Appellant,

v.

UNITED STATES,
Defendant-Appellant.

February 6, 2006, Decided

COUNSEL: Norman H. Singer, Singer and Associates, P. C., of Bethesda, Maryland, argued for plaintiff-cross appellant. Of counsel was Benjamin M. Kahrl.

David B. Stinson, Trial Attorney, Commercial Litigation Branch, Civil Division, United States Department of Justice, of Washington, DC, argued for defendant-appellant. With him on the brief were Peter D. Keisler, Assistant Attorney General, David M. Cohen, Director, and Mark A. Melnick, Assistant Director. Of counsel were Gregory T. Allen, Attorney, Defense Contract Management Agency, of Manassas, Virginia, and Raymond J.M. Wong, Attorney, of Alexandria, Virginia.

Thomas M. Abbott, McKenna Long & Aldridge LLP, of Los Angeles, California for amicus curiae United States Chamber of Commerce. With him on the brief was

Mark R. Troy. Of counsel on the brief was Robin S. Conrad, National Chamber Litigation Center, of Washington, DC.

JUDGES: Before RADER, LINN, and PROST, Circuit Judges.

OPINION BY: PROST

OPINION: PROST, Circuit Judge.

This case arose from a dispute over the allowable costs in a cost-reimbursement contract between the United States and Information Systems and Networks Corporation ("ISN"), a Maryland S corporation. The United States Court of Federal Claims granted summary judgment in favor of ISN. It held that, under 48 C.F.R. § 31.205-41, the state income tax payments made by ISN's sole shareholder resulting from dividends received from ISN were allowable costs in the cost-reimbursement contract. Because the Court of Federal Claims improperly interpreted 48 C.F.R. § 31.205-41, we reverse and remand.

I

ISN is a Maryland corporation with one sole shareholder, Roma Malkani. ISN provides services to the United States through cost-reimbursement contracts. Under these contracts, the United States reimburses ISN for allowable costs incurred during performance of the contract. See 48 C.F.R. § 16.301-1 (2004). Each year ISN negotiates with the United States to determine ISN's allowable costs for that year. See 48 C.F.R. § 52.216-7(d)(2)(ii) (2004). A cost is

allowable only when the cost complies with all of the following requirements:

(1) Reasonableness.

(2) Allocability.

(3) Standards promulgated by the CAS Board, if applicable, otherwise, generally accepted accounting principles and practices appropriate to the circumstances.

(4) Terms of the contract.

(5) Any limitations set forth in this subpart.

48 C.F.R. § 31.202-2 (2004). As provided by the last of these requirements, allowable costs must conform to any of the specific limitations set forth in 48 C.F.R. §§ 31.201-205. Many of these limitations are enumerated in 48 C.F.R. § 31.205 and include rules for determining the allowability of forty-seven different types of costs. This case turns on the allowability of certain tax-related costs. Taxes are discussed in 48 C.F.R. § 31.205-41. That subsection states that some but not all taxes paid by an entity are allowable. See 48 C.F.R. § 31.205-41 (2004).

ISN elected to be a subchapter S corporation pursuant to 26 U.S.C. § 1362(a). In a traditional subchapter C corporation, there is what is known as double taxation. A corporation pays income tax on its corporate income. And, when the corporation distributes income to its shareholders, those shareholders also pay income tax on

those dividends. In contrast, an S corporation is only subject to single taxation. The corporation does not pay income tax on the income it generates. Rather, only the shareholders of the S corporation pay income tax on their corporate dividends. As discussed by the Court of Federal Claims,

"S corporations" as they are known, are small businesses, closely held by no more than 75 shareholders, 26 U.S.C. § 1361(b)(1)(A), and often held by a sole shareholder. S corporation status is a tax election designed to make the decision of small businesses to incorporate "tax neutral;" i.e., a business will incur the same tax liability on its income whether the owners of the business incorporate or not. Subchapter S accomplishes this by eliminating the "double taxation" that usually befalls normal corporate income.

Info. Sys. & Networks Corp. v. United States, 48 Fed. Cl. 265, 266 (2000). Many states have aligned their tax codes with the Federal Internal Revenue Code and these states treat S corporations for state income taxes just as the Internal Revenue Code treats S corporations for federal income taxes. In those states that recognize the single taxation of an S corporation, ISN has never paid state income tax. Instead, Ms. Malkani, ISN's sole shareholder, has received dividend income from ISN and Ms. Malkani has paid state income tax on those dividends.

As part of its proposal for reimbursement under its contract with the United States, ISN submitted proposals for reimbursement for costs associated with Ms. Malkani's state income tax payments. The Defense

Council Audit Agency (the "DCAA") denied all of ISN's relevant claims for allowable costs for Ms. Malkani's state income tax payments. The DCAA found that, because ISN was an S corporation and not subject to state income taxes, the state income taxes paid by Ms. Malkani were not allowable costs for ISN. On April 16, 1998, the Contracting Officer issued a final decision denying ISN's claims.

On August 18, 1998, ISN filed suit in the Court of Federal Claims. ISN alleged that it had reimbursed Ms. Malkani for her state income tax and ISN asked the Court of Federal Claims to declare those reimbursements to be allowable costs under the cost-reimbursement contract. The court issued its decision on liability on November 30, 2000. The Court of Federal Claims granted ISN's motion for summary judgment and held that state income tax payments made by ISN's sole shareholder of an S corporation were allowable costs. As allowable costs, ISN was to receive reimbursement for them. As a result, on July 7, 2004, the Court of Federal Claims issued its decision on damages and it held that $ 1,133,176 that had been paid for state income taxes by Ms. Malkani were allowable costs and should be included in the compensation for the cost-reimbursement contract. Info. Sys. & Networks Corp. v. United States, No. 98-663C (Ct. Fed. Cl. July 21, 2004).

The United States filed this appeal on September 10, 2004. This court has jurisdiction to entertain this appeal pursuant to 28 U.S.C. § 1295(a)(3). ISN cross-appeals the Court of Federal Claims' denial of ISN's request for a money judgment as well as interest under the Contracts Dispute Act of 1978. See 41 U.S.C. § 601.

II

This court reviews grants of summary judgment by the Court of Federal Claims de novo. Costain Coal, Inc. v. United States, 126 F.3d 1437, 1440 (Fed. Cir. 1997). "On appeal, this court conducts a 'complete and independent review' of the record to determine whether summary judgment is appropriate." Argent v. United States, 124 F.3d 1277, 1281 (Fed. Cir. 1997) (quoting Tabb Lakes, Ltd. v. United States, 10 F.3d 796, 799 (Fed. Cir. 1993)). A grant of summary judgment is appropriate "'where the record shows 'that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.'" Id. at 1280.

The Court of Federal Claims concluded that state income taxes incurred by a shareholder of an S corporation are allowable costs. The court reached this conclusion based on its interpretation of both subparts (a) and (b) of 48 C.F.R. § 31.205-41. Discussing which taxes are specifically not allowable, the Court of Federal Claims held that costs are not allowable for "taxes from which exemptions are available to the contractor directly . . . . The term exemption means freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise." 48 C.F.R. § 31.205-41(b) (2004); see also Info. Sys. & Networks, 48 Fed. Cl. at 270. In addition, the Court of Federal Claims noted that subpart (a) of the regulation states that some income taxes are allowable. The regulation states that "the following types of costs are allowable: . . . State . . . taxes . . . that are required to be and are paid . . . ." 48 C.F.R. § 31.205-41(a) (2004); see

also Info. Sys. & Networks, 48 Fed. Cl. at 270. Addressing these two provisions the Court of Federal Claims concluded that the state income taxes claimed by ISN were allowable costs because they were not exempted taxes under 48 C.F.R. § 31.205-41(b) and that they were instead allowable taxes under 48 C.F.R. § 31.205-41(a). The court held that "the state income taxes were required to be paid and were paid, and because the tax liability on the corporate income was not subject to abatement or reduction, the state income taxes claimed by the plaintiff for reimbursement are allowed under the Taxes Provision." Id. We agree with the United States that the Court of Federal Claims' interpretation of the regulation was incorrect.

The language of the regulation makes it clear that the term exemption "means freedom from taxation in whole or in part." 48 C.F.R. § 31.205-41(b) (2004). After stating that general standard, the regulation states that a tax exemption "includes a tax abatement or reduction." Id. There is nothing that supports the Court of Federal Claims' interpretation of the regulation wherein tax abatements and tax reductions represent the exhaustive list of exempt taxes. Tax abatements or tax reductions are not the only types of exempt taxes. Instead, they are only two examples. Furthermore, the Court of Federal Claims also held that "the state income taxes were required to be paid and were paid," and therefore the costs claimed by ISN were allowable under 48 C.F.R. § 31.205-41(a). Info. Sys. & Networks, 48 Fed. Cl. at 270. But this inference is also incorrect. The allowable taxes described in 48 C.F.R. § 31.205-41(a) apply to taxes paid by the contracting entity. As an S corporation, ISN never paid any state income taxes. Only Ms. Malkani paid state income taxes on

dividends paid to her from ISN. Because she is not the contracting entity, 48 C.F.R. § 31.205-41 is inapplicable to Ms. Malkani's state income tax payments. The Court of Federal Claims incorrectly concluded that, because the state income tax liability was not a tax reduction nor a tax abatement, the state income tax liability could not be an exempt tax under 48 C.F.R. § 31.205-41(b).

The Court of Federal Claims' review of various state tax provisions relating to S corporation taxation does not change our view. In discussing those provisions, the court noted that "inspection of the tax codes of the states involved in this case . . . shows that the relationship between an S corporation and its shareholders is an important and intermingled one for state tax purposes." Info. Sys. & Networks, 48 Fed. Cl. at 271. The Court of Federal Claims found that "in general, the state tax codes explain that any corporation which fails to pay its state income taxes, no matter what tax election status it holds, will be subject to penalty and encumbrance on its ability to do business within the state." Id. This, however, is not enough to establish that the tax liability of an S corporation shareholder is an allowable cost for the corporation. In fact, the Court of Federal Claims' characterization of these state tax provisions suggests, though not conclusively, the opposite result. As the reviewed state tax liabilities are described as penalties and encumbrances, this suggests that these costs are generally not allowable costs. Another subpart of the regulations discusses the allowability of penalties:

Costs of fines and penalties resulting from violations of, or failure of the contractor to comply with, Federal, State, local, or foreign laws and regulations, are

unallowable except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.

48 C.F.R. § 31.205-15(a) (2004). The Court of Federal Claims' reliance on state tax provisions that describe penalties for failure to have shareholders pay the proper state income tax does not establish that an S corporation shareholder's state income tax payments should be an allowable cost to the corporation.

The plain language of 48 C.F.R. § 31.205-41(b) states that taxes from which the contracting entity is exempt are not allowable costs. This is the case here. ISN is free from taxation on Ms. Malkani's income derived from ISN's corporate dividends. Therefore, in its cost-reimbursement contract, Ms. Malkani's state income tax payments themselves cannot be an allowable cost for ISN.

III

For the reasons stated, the Court of Federal Claims improperly interpreted 48 C.F.R. § 31-205-41(b) too narrowly and it therefore improperly concluded that Ms. Malkani's state income tax payments were allowable costs. This court reverses the Court of Federal Claims' grant of summary judgment in favor of ISN and remands the case to the Court of Federal Claims for further proceedings consistent with this opinion. As this court reverses the grant of summary judgment, ISN's counterclaim for money damages and interest is rendered moot.

COSTS

No costs.

REVERSE AND REMAND

No. 98-663C

UNITED STATES COURT OF FEDERAL CLAIMS

INFORMATION SYSTEMS & NETWORKS CORPORATION,
Plaintiff,

v.

THE UNITED STATES,
Defendant.

November 30, 2000, Filed

COUNSEL: Norman H. Singer, Bethesda, Maryland, attorney of record for plaintiff. A. Daniel Ullman II, of counsel.

Erin E. Powell, Department of Justice, Washington, D.C., with whom was Acting Assistant Attorney General David W. Ogden, for defendant. David M. Cohen, Director, and Mark A. Melnick, Assistant Director.

JUDGES: BOHDAN A. FUTEY, Judge.

OPINIONBY: BOHDAN A. FUTEY

OPINION:

Futey, Judge.

This case is before the court on the parties' cross-motions for summary judgment. Plaintiff Information Systems & Networks Corporation appeals from the

final decision of the Contracting Officer (CO) denying plaintiff's claims for reimbursement of state income taxes paid on income derived from government cost-reimbursement and time-and-materials contracts. Plaintiff asks for a declaratory judgment from this court stating that (1) payment of state income taxes by its sole shareholder on behalf of plaintiff, a Subchapter S corporation, is a reimbursable, allowable cost under the Federal Acquisition Regulations (FAR); and (2) such payment should be allowed to be included in plaintiff's indirect rate cost pool for the contracts performed by plaintiff for the United States government (defendant). Plaintiff also asks for attorney fees and costs. Plaintiff argues that the pertinent provisions of the FAR regarding allowability of costs, and specifically of taxes paid, apply in favor of plaintiff and its sole shareholder because (1) the FAR provisions were intended to include such tax reimbursement; and (2) an agreement between plaintiff and its sole shareholder obligated plaintiff to reimburse the sole shareholder for the taxes (Agreement), therefore creating a valid and reasonable cost to plaintiff that is reimbursable under the FAR. Defendant contends that because plaintiff is an S corporation, its income tax liability is "passed through" to the sole shareholder, and therefore plaintiff did not have to pay, nor did it pay, state income taxes as a result of the contracts at issue. Defendant argues instead that the tax liability belonged exclusively to the sole shareholder, and as such is personal liability that is not reimbursable under the FAR.

Factual Background

Plaintiff is a corporation organized under Subchapter S of the Internal Revenue Code (IRC), *26*

U.S.C. § § 1361-1379 (1994 & Supp. V 1999). "S corporations," as they are known, are small businesses, closely held by no more than 75 shareholders, *26 U.S.C. § 1361* (b)(1)(A), and often held by a sole shareholder. S corporation status is a tax election designed to make the decision of small businesses to incorporate "tax neutral;" i.e., a business will incur the same tax liability on its income whether the owners of the business incorporate or not. Subchapter S accomplishes this by eliminating the "double taxation" that usually befalls normal corporate income. *See 26 U.S.C. § 1363.* With an ordinary corporation, or "C corporation," the corporate entity must pay income taxes on its income. Then, when the corporation distributes after-tax income to its shareholders, those shareholders must pay personal income tax on that source of income. In the case of an S corporation, no income tax liability accrues to the corporation. Instead, the corporation's income is "passed through" to the shareholders, and is attributed to the shareholders' personal income tax liability in pro rata amounts. *26 U.S.C. § 1366.* States have the option of recognizing the federal S corporation designation by aligning their tax codes with the IRC to allow the transfer of income tax liability of the corporation to the personal tax liability of the shareholders. Most states have adopted the same treatment of S corporations as the federal government. The state income taxes for which plaintiff has asked reimbursement from the government all were imposed in states that have adopted the S corporation tax treatment found in the IRC. n1

Plaintiff has a sole shareholder, Roma Malkani, and therefore the entire income tax liability of plaintiff is passed through to her personal income tax liability.

Plaintiff alleges that it and Ms. Malkani, however, entered into the Agreement, referenced above. In accordance with the Agreement, Ms. Malkani has indeed paid the state income taxes incurred by plaintiff on her own income tax returns, but pursuant to a regular course of practice has been reimbursed by plaintiff for the payment of those taxes. Defendant claims that plaintiff has not satisfactorily proven the existence of the Agreement, as it is mentioned only in an affidavit and a deposition, and plaintiff has provided no written memorialization of the Agreement. Defendant does not dispute, however, that Ms. Malkani paid the taxes at issue, and that plaintiff reimbursed her for such tax payment.

Plaintiff and defendant entered into several cost-reimbursement and time-and-materials contracts in the 1980's and early 1990's. These types of contracts provide a cost ceiling for the work performed on a contract and permit the government to pay up to that ceiling amount for allowable incurred costs of the contractor for the contract work. *48 C.F.R. § 16.301-1 (2000)*. This arrangement is made for contracts for which the contract price is not readily ascertainable at the time of contracting. Id. During performance of one of these contracts the contractor incurs direct (e.g., materials, labor, equipment costs) and indirect (e.g., taxes, rental space, insurance) costs. Both direct and indirect costs are generally allowable for reimbursement. *48 C.F.R. § 31.201-1(a) (2000)*. After performance, a contractor requests reimbursement for indirect costs via an "indirect rate proposal," which relates back to the agreed-upon rates for allowable costs for that certain type of contract. This proposal requests that the various claimed costs be included in

the "rate pool." n2 The government then determines what costs are allowable, determines the proper contents of the rate pool, adjusts the rate of reimb rsement accordingly, and pays the contractor for its all(vable costs.

Plaintiff submitted final indirect rate proposals for fiscal years (FY) 1985-91. It claimed reimbursable expenses for state income taxes paid in each of those proposals within its "general and administrative expense rate pool." Plaintiff relied on information from outside sources that other S corporations had been reimbursed for state income taxes in this manner. n3 In each case, excepting FY 1990, the Defense Contract Audit Agency (DCAA), which processed the proposals, denied plaintiff's claims for state income taxes, explaining that the taxes paid were unallowable. n4 DCAA based its decision on the fact that plaintiff was an S corporation, and therefore was not subject to state income tax:

> The contractor is a Sub-Chapter S Corporation. As such, with few exceptions, the corporation is not taxed by the states on its income; rather the income flows to the stockholders who pay tax on their personal income tax returns. Thus, this is a personal tax expense to the shareholders. The state income taxes of individuals are not allocable to the company, as described in [*48 C.F.R. §] 31.201-4*, Determining allocability, and therefore, are not part of the contract costs directly or indirectly. n5

Despite continuing correspondence between the parties, plaintiff and defendant reached an impasse

concerning the reimbursement of the state income taxes. After the DCAA disallowances of tax costs, plaintiff twice requested a final decision from the CO concerning its indirect rate proposals for reimbursement of taxes. n6 On April 16, 1998, the CO issued a final decision denying plaintiff's claims for FY 1985 and 1986, and demanded repayment of previous reimbursement to plaintiff that it deemed as unallowable costs. n7 On August 18, 1998, plaintiff filed suit in this court, asking the court to declare the taxes paid by Ms. Malkani, and subsequently reimbursed by plaintiff, to be allowable under the pertinent provisions of the FAR. Defendant counterclaimed, asking for the return of its previous improper reimbursement of a portion of plaintiff's incurred state income taxes. The parties proceeded to file motions for summary judgment in this matter.

Discussion

Plaintiff asks for declaratory judgment in this case. As a general rule, this court does not have jurisdiction over such claims, and does not have the authority to issue declaratory judgments. *See 28 U.S.C. § 2201* (1994) (stating only a "court of the United States" can issue declaratory judgments); *28 U.S.C. § 451* (1994) (excluding the Court of Federal Claims from the definition of "court of the United States"). In 1992, however, this court's jurisdiction was enlarged by amendment of the Tucker Act, the court's jurisdictional foundation. The Tucker Act, *28 U.S.C. § 1491*(a)(2) (1994), now states that the court has jurisdiction to render judgment on nonmonetary claims brought in this court under section 10(a)(1) of the Contract Disputes Act of 1978 (CDA), *41 U.S.C. § 609*(a)(1) (1994), based on denials of contractor claims to CO's

under section 6 of the CDA, *41 U.S.C. § 605* (1994 & Supp. III 1997). A complaint for declaratory judgment appealing a denial of claims by a CO's final decision falls within the court's jurisdiction over "nonmonetary claims." *Emery Worldwide Airlines, Inc. v. United States, 47 Fed. Cl. 461, 468 (2000); see Alliant Techsystems, Inc. v. United States, 178 F.3d 1260, 1268 (Fed. Cir. 1999).*

In this case, plaintiff appeals a final decision by the CO under section 6(a) of the CDA denying reimbursement for the taxes paid in FY 1985 and 1986, and appeals a deemed denial (due to the CO's failure to issue a final decision within 60 days) of its claims for taxes paid FY 1987-91 under section 6(b)(5) of the CDA. It has brought its claims in this court under section 10(a)(1) of the CDA. This court has jurisdiction, therefore, over plaintiff's claims for declaratory judgment.

I. Summary Judgment

The parties have filed cross-motions for summary judgment. Summary judgment is appropriate when there are no genuine issues of material fact and the moving party is entitled to judgment as a matter of law. RCFC 56(c); *Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 247, 91 L. Ed. 2d 202, 106 S. Ct. 2505 (1986), cited in Jay v. Secretary, DHHS, 998 F.2d 979, 982 (Fed. Cir. 1993).* A fact is material if it might significantly affect the outcome of the suit under the governing law. *Anderson, 477 U.S. at 248.* The fact that both parties have moved for summary judgment does not relieve the court of its responsibility to determine the appropriateness of summary disposition. *Prineville Sawmill Co. v. United States, 859 F.2d 905, 911 (Fed.*

Cir. 1988)(citing *Mingus Constructors, Inc. v. United States, 812 F.2d 1387, 1390 (Fed. Cir. 1987)).* A cross-motion is a party's claim that it alone is entitled to summary judgment. *A Olympic Forwarder, Inc. v. United States, 33 Fed. Cl. 514, 518 (1995).* It does not follow that if one motion is rejected, the other is necessarily supported. *Id.* Rather, the court must evaluate each party's motion on its own merit and resolve all reasonable inferences against the party whose motion is under consideration. *Id.* (citing *Corman v. United States, 26 Cl. Ct. 1011, 1014 (1992)).*

FAR Part 31, Contract Cost Principles and Procedures, Subpart 31.2, Contracts With Commercial Organizations, establishes a set of principles and provisions for the reimbursement of costs for contractors performing the type of contract at issue in this case. The section named "Determining allowability" states that costs generally must meet two criteria in order to be an allowable expense: first, the cost must be reasonable, and second, it must be allocable. *48 C.F.R. § 31.201-2(a)(1)*,(2) (2000). The "Determining reasonableness" provision states that a cost is reasonable when it is incurred in accord with sound, generally accepted business principles, and that a prudent person engaged in a competitive business would expect to incur such cost ordinarily and necessarily when completing contract work for the government. *48 C.F.R. § 31.201-3 (2000).* In the "Determining allocability" section, the FAR provides that the amount claimed must be chargeable generally to a cost objective of the contractual relationship between the contractor and the government in order to be allocable and therefore reimbursable. *48 C.F.R. § 31.201-4(a),* (b) (2000). Subsection (c) of the provision

states, however, that expenses which are not directly attributable to contract work, but nonetheless are necessary for the overall operation of the contractor's business, are allocable. § 31.201-4(c). The government will make payments for reimbursement costs only when a claimant shows that such costs are allowable. *48 C.F.R. § 52.216-7 (2000).*

In addition, specifically provided in the FAR provisions regarding reimbursement is the section entitled "Taxes," which provides the basis for the reimbursement of certain tax expenditures of contractors performing cost-reimbursement contracts for the government. *48 C.F.R. § 31.205-41 (2000)* (Taxes Provision). The section states that certain federal, state and local taxes are allowable if they "are required to be and are paid or accrued in accordance with generally accepted accounting principles." § 31.205-41(a)(1). State income taxes in general are allowable costs under the section. *See* § 31.205-41(a), (a)(1), (b). If the contractor is exempt from a certain tax liability, however, and still proceeds to pay such tax, that tax expenditure is not allowable. § 31.205-41(b)(3).

Plaintiff argues first that the Taxes Provision intends to compensate for taxes paid by all types of "commercial organizations," including S corporations, because Subpart 31.2 applies to all such organizations, and nothing in any of the reimbursement sections states that certain organizations would be treated differently from others. Second, plaintiff maintains that it is required by state law to ensure the timely and appropriate payment of taxes required of Ms. Malkani due to plaintiff's business activities and corporate income, otherwise its corporate charter could be forfeited. Plaintiff avers that it executed the

Agreement with Ms. Malkani under which plaintiff paid Ms. Malkani for her personal income taxes incurred on plaintiff's corporate income. n8 Plaintiff therefore asserts that (1) the tax itself had to be paid by Ms. Malkani; (2) plaintiff was required to pay for the expense equal to the additional tax burden of Ms. Malkani; and (3) the expenditure incurred pursuant to the Agreement is reasonable and allocable, because it was necessary to maintain its charter and therefore its ability to continue performing work on its contracts with the government.

Defendant responds simply that the state law applicable to this case places the ultimate responsibility to pay the pass-through income taxes on plaintiff's corporate income squarely on Ms. Malkani; it concludes, therefore, that an S corporation has no responsibility to pay state income taxes or ensure such payment. According to defendant, because plaintiff did not have to pay state income taxes, plaintiff's claims for reimbursement are not allowable under the Taxes Provision, nor is such payment reasonable or allocable under the general provisions regulating reimbursement.

The court must first determine if the Taxes Provision was meant to allow reimbursement of state income taxes paid as a result of plaintiff's performance of government contracts, even if plaintiff itself was not technically required to pay the taxes. There is little in the way of guidance on this question. When the court undertakes interpretation of a federal regulation, it will rely first on its plain language. *PCA Health Plans of Texas v. LaChance, 191 F.3d 1353, 1355 (Fed. Cir. 1999).* Also, the court will accord some deference to the

construal of the regulation by an agency's board of appeals, when such board possesses particular expertise in determining the meaning of the regulation. *Titan Corp. v. West, 129 F.3d 1479, 1481 (Fed. Cir. 1997).* n9

The language of the Taxes Provision states that when a contractor pays taxes from which it is exempt, the contractor will not qualify for reimbursement for the tax payment:

> (b) The following types of costs are not allowable:
>
> . . . .
>
> (3) Taxes from which exemptions are available to the contractor directly . . . . The term *exemption* means freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise.

48 C.F.R. § 31.205-41(b), (b)(3). Although technically plaintiff is "exempt" from paying state income taxes due to its S corporation status, this is not a tax exemption in the normal sense of the term. Usually when an entity or individual is exempt from taxation, the result is the complete absence of payment of that tax, either by the exempted party or any other party. This absence of payment requirement is embodied in the term "abatement" included in the exemption definition in the Taxes Provision. § 31.205-41(b)(3). n10 In plaintiff's

situation, however, the exemption is not an abatement of tax liability, but a transfer of liability. Plaintiff, as an S corporation, is not relieved of state tax liability, but is simply required to pass its liability on its corporate income to Ms. Malkani. The Taxes Provision's language does not require that any specific part of a corporation pay the state income taxes: "The following types of costs are allowable: . . . States . . . taxes . . . that are required to be and are paid . . . ." § 31.205-41(a), (a)(1). Because the state income taxes were required to be paid and were paid, and because the tax liability on the corporate income was not subject to abatement or reduction, the state income taxes claimed by plaintiff for reimbursement are allowed under the Taxes Provision. n11

This interpretation of the Taxes Provision comports with the general intent of the FAR and the IRC. Nothing in the FAR provisions involved in this case points to an intent that certain types of commercial organizations should be denied reimbursement altogether simply because of their tax election or corporate structure. Nor does the purpose behind Subchapter S of the IRC include any desire that the structure of pass-through taxation would cause a corporation to lose out on reimbursement due to its tax election. Neither the FAR nor Subchapter S state that an S corporation is only allowed one type of tax relief, either pass-through taxation or cost-reimbursement. Indeed, S corporations are small businesses and their corporate structure is meant to help, not hinder, the growth and health of these businesses. It is the general intent of the FAR to aid and encourage small businesses as well. n12

In addition, to interpret the provision in this way does not frustrate the purpose of reimbursement. There is no question that the taxes have been paid, nor that the reimbursement sought by plaintiff is meant precisely to cover that payment. Also, the government will completely discharge its duty to reimburse when it pays the costs of these taxes, even though the money will go directly to plaintiff, and not Ms. Malkani. This reimbursement is especially justified when, as in this case, an S corporation has first reimbursed its shareholder for the payment of taxes. In addition, it seems that other S corporations have been reimbursed in exactly the same way as plaintiff is asking here. Ms. Malkani paid the income taxes incurred by plaintiff. Plaintiff recompensed Ms. Malkani for such payment. Pursuant to the Taxes Provision, therefore, defendant is obligated to reimburse plaintiff for this transferred pass-through tax expenditure. n13

Defendant nevertheless relies upon the obvious general proposition that because only the shareholders of an S corporation are required to pay taxes on corporate income, and not the corporation itself, the two tax liabilities are completely separate. Defendant therefore asserts that plaintiff has no basis for requesting reimbursement for the tax expenditures of Ms. Malkani. Inspection of the tax codes of the states involved in this case, however, shows that the relationship between an S corporation and its shareholders is an important and intermingled one for state tax purposes. The most useful examples of this relationship exist in the provisions concerning nonresident shareholders. *E.g., Va. Code Ann. § 58.1-332(C)* (Michie 1997).

To begin, the states require an S corporation to file a tax return for its corporate income, despite the fact that the corporation will never pay taxes on such income. *E.g., N.C. Gen. Stat. § 105-131.7(a)* (1999). With its return, an S corporation in many states must file agreements by its nonresident shareholders that they will pay their share of the income taxes incurred by the corporation. *N.C. Gen. Stat. § 105-131.7(c)(i)*; *R.I. Gen. Laws § 44-11-2(d)(3)* (1995); *Ga. Code Ann. § 48-7-27(d)(2)* (1995). Other states require the corporation to furnish extensive information on each shareholder. *S.C. Code Ann. § 12-8-590(B)* (Law. Co-op. Supp. 1999). Shareholders must in some cases subject themselves explicitly to personal jurisdiction in the state in order for the S corporation to enjoy pass-through taxation status. *N.C. Gen. Stat § 105-131.7(c)(ii)*; *S.C. Code Ann. § 12-8-590(F)(3)*. Some tax codes provide that if an S corporation fails to file such agreements, the S corporation must pay a penalty. *Ga. Code Ann. § 48-7-129(a)(3)* (1995 & Supp. 1999). In some circumstances, certain tax codes require an S corporation to withhold state taxes on behalf of nonresident shareholders, and arrange for reimbursement from these shareholders at a later date. Md. Code Ann. Tax § 10-102.1(b)(1), (2), (c) (1997); *Ga. Code Ann. § 48-7-129(a)(1)*; *S.C. Code Ann. § 12-8-590(A)*; *Ind. Code § 6-3-4-13* (1996); Ind. Admin. Code tit. 45, r. 3.1-1-66 (1992); *Ind. Code § 6-8.1-10-2.1(h)* (1996) (penalties levied for failure to withhold). Others actually require the corporation to pay the corporate income taxes automatically, or if the shareholder fails to pay. *N.C. Gen. Stat § 105-131.7(c)*; *R.I. Gen. Laws § 44-11-2(d)(4)(i)*-(ii); Ind. Admin. Code tit. 45, r. 3.1-1-109 (1992). In general, the state tax codes explain that any corporation which fails to pay its state income

taxes, no matter what tax election status it holds, will be subject to penalty and encumbrance on its ability to do business within the state. *See, e.g., Md. Code Ann. Corps. & Ass'ns § 3-503(a)(1),* (2) (1997); *Ohio Rev. Code Ann. § 5733.20* (Anderson 1999). n14 The obligations of an S corporation and its shareholders to pay state income taxes are therefore closely intertwined, and an S corporation is very much required to ensure the payment of its state income taxes. The rigid argument that the tax liabilities of plaintiff and Ms. Malkani are completely separate does not suffice to prohibit reimbursement. Defendant is therefore obligated to reimburse plaintiff for the necessary expenditure plaintiff makes and has made to ensure the payment of its incurred state income taxes.

Conclusion

For the above-stated reasons, the Taxes Provision, *48 C.F.R. § 31.205-41,* allows an S corporation to recover costs associated with the payment of state income taxes incurred on its corporate income. The state tax expenditures incurred by plaintiff on its business activities related to its cost-reimbursement contracts with defendant are therefore reimbursable under the FAR. Plaintiff's motion for summary judgment is granted. Defendant's cross-motion for summary judgment is denied. Pursuant to this holding, defendant's counterclaim for the return of its previously paid state income tax reimbursement to plaintiff is dismissed.

The parties are directed to file a joint stipulation as to the amount of taxes to be reimbursed in accordance with this ruling no later than December 28, 2000. The Clerk is directed to enter judgment in the amount

stipulated without further order of the court. Plaintiff's claim for attorney fees and costs is denied without prejudice at this time. Plaintiff may file its brief requesting attorney fees and costs pursuant to the Equal Access to Justice Act, *28 U.S.C. § 2412* (1994 & Supp. IV 1998). No costs.

IT IS SO ORDERED.

BOHDAN A. FUTEY

Judge

n1 These states are Maryland, Ohio, Indiana, Georgia, Virginia, Rhode Island, North Carolina and South Carolina.

n2 Claims for state income taxes are included within a contractor's proposed "general and administrative expense rate pool."

n3 Ms. Malkani, in her capacity as plaintiff's president, explained in a letter to the CO that DCAA had previously allowed state income taxes paid by S corporation shareholders as costs. Ms. Malkani stated that DCAA had allowed as costs the state income taxes of Executive Resource Associates, Inc., another S corporation. Plaintiff's/Counterclaim Defendant Information Systems & Networks Corporation's Motion for Summary Judgment, Appendix, Exhibit 8, Letter of May 2, 1996 from Ms. Malkani to the CO.

n4 Plaintiff claimed only $ 404 in FY 1990 for reimbursement of state income taxes, and therefore DCAA considered it an insignificant amount and allowed the claim. DCAA disallowed the tax costs for FY 1985 and 1986 on November 1, 1994, and disallowed the tax costs for FY 1987-89 and 1991 on May 23, 1995.

n5 Defendant's Cross-Motion for Summary Judgment and Opposition to Plaintiff's Motion for Summary Judgment, Appendix, Exhibit 3, DCAA Audit Report of Nov. 1, 1994.

n6 Plaintiff requested reimbursement in the amount of $ 294,052 in the second request for final decision, and certified the claim under *48 C.F.R. § 52.233-1 (2000)*, as the claim amounted to more than $ 100,000.

n7 The CO directed plaintiff to pay $ 262,515, with $ 17,274 of the total representing unallowable state income tax reimbursement for FY 1985 and 1986.

n8 Although defendant questions whether the Agreement actually exists, the fact that this Agreement was never executed would not change the court's analysis. The operative fact is not whether plaintiff agreed to reimburse Ms. Malkani for the payment of the pass-through corporate income taxes, but is instead whether plaintiff actually did reimburse Ms. Malkani for those tax payments. It is not disputed that Ms. Malkani paid the state income taxes at issue in this case, nor that plaintiff reimbursed Ms. Malkani for these payments.

n9 Unfortunately, few board of appeal decisions have attempted to interpret the Taxes Provision. Although none has dealt specifically with the issue of whether state income taxes are allowable for S corporations, the General Services Board of Contract Appeals (GSBCA) has heard claims for such reimbursement. At no time in the resolution of those claims has the GSBCA made any reference to a blanket prohibition on the allowability of state income taxes for S corporations due to the pass-through nature of their tax liability, and has instead treated S corporations in no special manner on claims for reimbursement of such taxes. *See, e.g., Singleton Contracting Corp., 1990 GSBCA LEXIS 309, 90-3 B.C.A. (CCH) P23,125*, GSBCA No. 9614 (June 1, 1990).

n10 Abatement, as applied to the payment of taxes, is thus defined: "Diminution or decrease in the amount of tax imposed. Abatement of taxes relieves property of

its share of the burdens of taxation after the assessment has been made and the tax levied." Black's Law Dictionary 4 (5th ed. 1979). In this case, the property involved, plaintiff's corporate income, has not been relieved of its tax burden. Instead, the property is taxed through Ms. Malkani's personal tax liability instead of plaintiff's corporate tax liability.

n11 Indeed, the restriction in the Taxes Provision, precluding allowance of taxes when the contractor is exempt from such tax, § 31.205-41(b)(3), is most likely primarily to preclude a contractor's double recovery of taxes. A contractor that unnecessarily pays taxes to a state will undoubtedly be able to recover those payments in refunds from the state. The reimbursement of such erroneous payments as contract costs as well would unjustly enrich a contractor, therefore, as the contractor could recover the same amount from the government, as costs, and from the state tax authority, as refunds. The Taxes Provision merely cuts off the chance for such double recovery. Subsection (b)(3) of the Taxes Provision is complemented by subsection (d), which states that any taxes later refunded to a contractor from the taxing entity will be returned to the government when the government had previously reimbursed such taxes as allowable costs. In this case, however, no refund is available from the state tax authority. The taxes were not erroneously or mistakenly paid, but in fact were required to be paid. No double recovery is available here, and therefore the taxes are allowable costs under the Taxes Provision.

n12 As another policy issue, a finding by this court that the Taxes Provision precludes allowability of state

income taxes paid by shareholders of S corporations would most likely harm the financial interests of the federal government in the future. Government contractors that elect S corporation status pay taxes on corporate income at a lower rate than normal C corporations. If the Taxes Provision does not allow reimbursement for state income taxes for S corporations, such corporations will most likely change their tax election to C corporation status in order to benefit from the cost reimbursement available from the Taxes Provision. This change in election would cause these government contractors to be taxed at the higher C corporation rates, and therefore the amount the federal government will be required to reimburse will be higher as a result.

n13 The parties also dispute whether the general provisions concerning reasonableness, *48 C.F.R. § 31.201-3*, allocability, *48 C.F.R. § 31.201-4*, and allowability, *48 C.F.R. § 31.201-2*, require defendant's reimbursement of plaintiff's repayment to Ms. Malkani for her payment of plaintiff's incurred income taxes under the Agreement. Because the more specific Taxes Provision allows for such reimbursement, however, the court need not enter into this discussion in order to rule properly in this case.

n14 This discussion is not meant to apply these statutory provisions directly to plaintiff's situation; instead, it illustrates an overall unseparated approach to the tax liability of S corporations and their shareholders in the states involved in this case.

04-5151, 04-5154

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

INFORMATION SYSTEMS & NETWORKS CORPORATION,
Plaintiff-Cross Appellant,

v.

UNITED STATES,
Defendant-Appellant.

April 14, 2006, Decided

April 14, 2006, Filed

NOTICE: THIS DECISION WAS ISSUED AS UNPUBLISHED OR NONPRECEDENTIAL AND MAY NOT BE CITED AS PRECEDENT. PLEASE REFER TO THE RULES OF THE FEDERAL CIRCUIT COURT OF APPEALS FOR RULES GOVERNING CITATION TO UNPUBLISHED OR NONPRECEDENTIAL OPINIONS OR ORDERS.

OPINION: ORDER

A combined petition for panel rehearing and for rehearing en banc having been filed by the Cross-Appellant, and the petition for rehearing, having been referred to the panel that heard the appeal, and thereafter the petition for rehearing en banc having been referred to the circuit judges who are in regular active service,

UPON CONSIDERATION THEREOF, it is

ORDERED that the petition for panel rehearing be, and the same hereby is, DENIED and it is further

ORDERED that the petition for rehearing en banc be, and the same hereby is, DENIED.

The mandate of the court will issue on April 21, 2006.

United States Constitution, Article I, Section 8:

The Congress shall have the Power To lay and collect Taxes....

United States Constitution, Amendment V:

No person shall...be deprived of life, liberty, or property, without due process of law....

United States Constitution, Amendment XVI:

The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived.....

48 CFR Section 31.201-1(a)(Contracts with Commercial Organizations):

The total cost, including standard costs properly adjusted for applicable variances, of a contract is the sum of the direct and indirect costs allocable to the contract....

48 CFR Section 31.201-2 (Determining allowability):

(a) A cost is allowable only when the cost complies with all of the following requirements:

(1) Reasonableness.

(2) Allocability.

(3) Standards promulgated by the CAS Board, if applicable, otherwise, generally accepted accounting principles and practices appropriate to the

circumstances.

(4) Terms of the contract.

(5) Any limitations set forth in this subpart....

48 CFR Section 31.201-3(a) (Determining reasonableness):

A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business....

48 CFR Section 31.201-4(a) (Determining allocability):

A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship...[and] is incurred specifically for the contract...or is necessary for the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.

48 CFR Section 31.205-15(a) (Fines, penalties and mischarging costs):

Costs of fines and penalties resulting from violations of, or failure of the contractor to comply with, Federal, State, local, or foreign laws and regulations, are unallowable except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.

48 CFR Sections 31.205-41(a)(1) and (b)(3) (Taxes):

(a) The following types of costs are allowable:

(1) Federal, State, and local taxes...that are required to be and are paid or accrued in accordance with generally accepted accounting principles....

....

(b) The following types of costs are not allowable:

....

(3) Taxes from which exemptions are available to the contractor directly, or available to the contractor based on an exemption Afforded the Government....The term *exemption* means freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise.

(emphasis in original).

No. 06-234

In the Supreme Court of the United States

INFORMATION SYSTEMS & NETWORKS CORPORATION,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

In Maryland, the shareholder of an S corporation pays personal income tax on her pro rata share of the corporation's gross income. The question presented is whether 48 C.F.R. 31.205-41 requires the government to reimburse petitioner, an S corporation and government contractor, for payments it made under a separate agreement with its sole shareholder, reimbursing her for the portion of her Maryland state income tax payments attributable to petitioner's income on its government contracts.

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In the Supreme Court of the United States

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INFORMATION SYSTEMS & NETWORKS CORPORATION, PETITIONER

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-10a) is reported at 437 F.3d 1173. The opinion of the Court of Federal Claims (Pet. App. 11a-30a) is reported at 48 Fed. Cl. 265.

JURISDICTION

The judgment of the court of appeals was entered on February 6, 2006. A petition for rehearing was denied on April 14, 2006 (Pet. App. 31a-32a). On July 11, 2006, the Chief Justice extended the time within which to file a petition for a writ of certiorari to and including August 14, 2006, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In the 1980s and 1990s, petitioner provided services to the federal government under cost-reimbursement contracts. Pet. App. 2a, 14a. A cost-reimbursement contract entitles a contractor to be reimbursed by the government for allowable costs incurred during performance of the contract. 48 C.F.R. 16.301-1. Besides the costs of material and labor, allowable costs also include state taxes "that are required to be and are paid" by the contractor, 48 C.F.R. 31.205-41(a)(1), unless the state taxes are, *inter alia*, taxes "from which exemptions are available to the contractor directly," 48 C.F.R. 31.205-41(b)(3).

2. Petitioner is a Maryland corporation with a single shareholder, Roma Malkani. Pet. App. 2a. Petitioner elected to be an S corporation under 26 U.S.C. 1362. Pet. App. 3a. S corporations are exempt from the federal corporate income tax, 26 U.S.C. 1363(a), and the Maryland state income tax, Md. Code Ann., Tax-Gen. § 10-104(6) (2004). A shareholder of an S corporation, however, pays federal income tax on his pro rata share of the corporation's income. See 26 U.S.C. 1366. Maryland also taxes a shareholder of an S corporation for his pro rata share of the corporation's income: specifically, Maryland bases its income tax on an individual's federal adjusted gross income, Md. Code Ann., Tax-Gen. § 10-203 (2004), which includes the pro rata share of the gross income of any S corporation for which he is a shareholder, 26 U.S.C. 1366(c).

Because petitioner is an S corporation, petitioner paid no federal or state income taxes on the income it received on its federal cost-reimbursement contracts. As petitioner's sole shareholder, Malkani paid income

taxes to Maryland on her pro rata share—*i.e.*, the entirety—of petitioner's income. Pet. App. 4a. Petitioner and Malkani had a side agreement pursuant to which petitioner agreed to pay Malkani money equal to the amount of her income tax payments attributable to petitioner's income. See *id.* at 12a; Pet. 5 ("[T]here was a valid, binding agreement between [petitioner] and its sole shareholder, Ms. Malkani, which obligated [petitioner] to reimburse her for the state income taxes she paid.").

3. Under its cost-reimbursement contracts, petitioner requested reimbursement from the government for the money petitioner paid Malkani under their separate agreement. Pet. App. 4a. Petitioner's request was denied, so petitioner brought this suit in the Court of Federal Claims, seeking a declaration that its payments to Malkani were allowable costs under the cost-reimbursement contracts. *Id.* at 5a. The Court of Federal Claims agreed and granted summary judgment to petitioner. *Id.* at 11a-30a. In its decision on damages, the court held that $1,133,176 of the money petitioner had reimbursed Malkani were allowable costs under petitioner's contracts. *Id.* at 5a.

4. The Federal Circuit reversed. Pet. App. 1a-10a. It based its decision on 48 C.F.R. 31.205-41(a), which provides that "The following types of costs are allowable: * * * State * * * taxes * * * that are required to be and are paid." The court of appeals held that "[t]he allowable taxes described in 48 C.F.R. § 31.205-41(a) apply to taxes paid by the contracting entity. As an S corporation, [petitioner] never paid any state income taxes. Only Ms. Malkani paid state income taxes." Pet. App. 7a.

ARGUMENT

The decision of the court of appeals is correct and addresses a straightforward issue of regulatory interpretation. Petitioner cites no decision of this Court or any other court of appeals that conflicts with the decision below. Accordingly, this Court's review is not warranted.

1. Petitioner argues (Pet. 5) that its payments to Malkani are allowable costs of performing its government cost-reimbursement contracts. Petitioner's payments to Malkani, however, were not costs it had to pay in order to fulfill its government contracts; instead, they were payments on its separate agreement with Malkani. Petitioner tries (Pet. 13-16) to link its cost-reimbursement contracts to its agreement with Malkani by reasoning that Malkani's tax liabilities were actually petitioner's own tax liabilities on its government contract, which had been "passed through" or "transferred" to Malkani. Thus, petitioner concludes, the government must reimburse it for the payments under 48 C.F.R. 31.205-41(a), which establishes the terms under which the government reimburses contractors for tax liabilities they incur in performing government contracts.

The court of appeals correctly held that 48 C.F.R. 31.205-41(a) does not apply to state income taxes incurred by a shareholder of an S corporation; rather, it applies only to taxes incurred and paid by the contracting entity. Pet. App. 6a-7a. As the court held, Malkani—not petitioner—incurred and paid the Maryland state taxes at issue in this case, and "[b]ecause she is not the contracting entity, 48 C.F.R. § 31.205-41 is inapplicable to Ms. Malkani's state income tax payments." *Id.* at 7a-8a. The court of appeals' decision re-

flects the elementary notion that a corporation and its sole shareholder are "legally different entit[ies] with different rights and responsibilities due to [their] different legal status." *Cedric Kushner Promotions, Ltd.* v. *King*, 533 U.S. 158, 163 (2001); cf. *Domino's Pizza, Inc.* v. *McDonald*, 126 S. Ct. 1246, 1250 (2006) ("[I]t is fundamental corporation and agency law—indeed, it can be said to be the whole purpose of corporation and agency law—that the shareholder * * * of a corporation has no rights and is exposed to no liability under the corporation's contracts."). The court's decision, furthermore, is consistent with its precedents upholding "the unexceptional proposition that a cost may not be charged against the government unless that cost is actually incurred by the contractor." *Riverside Research Inst.* v. *United States*, 860 F.2d 420, 424 (Fed. Cir. 1988) (discussing *Marquardt Co.* v. *United States*, 822 F.2d 1573 (Fed. Cir. 1987)), modified on reh'g, 877 F.2d 952 (Fed. Cir. 1989).

Even if petitioner, ignoring corporate formalities, were correct that its payments to Malkani were effectively payments of its own state income taxes because an S corporation, its shareholders, and their respective tax liabilities are "intermingled and intertwined" (Pet. 16), 48 C.F.R. 31.205-41(b)(3) states clearly that taxes "from which exemptions are available to the contractor directly" are not allowable costs. Petitioner, as an S corporation, is expressly exempted from the Maryland state income tax—*i.e.*, it neither incurs nor pays Maryland state income tax. See Md. Code Ann., Tax-Gen. § 10-104(6) (2004). The court of appeals correctly held (Pet. App. 6a-7a) that, even on petitioner's view, petitioner's Maryland state income tax exemption would trigger 48 C.F.R. 31.205-41(b)(3) such that petitioner

could not be reimbursed for money, no matter how circuitously paid, spent on Maryland state income taxes.

Petitioner's intermingling argument, moreover, is patently incorrect. Petitioner contends (Pet. 17) that, because some States require S corporations to pay state income taxes levied on their shareholders "either in the form of a corporate-level tax or in the form of a withholding tax," Malkani's Maryland income tax payments should be treated as the petitioner's own. As the Court of Federal Claims determined (Pet. App. 30a n.14), none of those state statutes actually applies to petitioner. Maryland, to be sure, does require Maryland S corporations to withhold with respect to *nonresident* shareholders. See Md. Code Ann., Tax-Gen. § 10-102.1(b) (Supp. 2006). Not only is that statute inapplicable in this case because Malkani was not a nonresident, see Gov't C.A. App. 57, but a state withholding requirement does not affect the incidence of the underlying tax. The Maryland statute is clear on that matter, for it expressly provides that the tax "shall be treated as a tax imposed on the nonresident," not the S corporation. Md. Code Ann., Tax-Gen. § 10-102.1(c)(1) (Supp. 2006).

Petitioner also argues (Pet. 17) that some States provide a "potential penalty" or an encumbrance on an S corporation's ability to do business in that State if the corporation's shareholders fail to pay state income taxes. Although Maryland law provides that a Maryland corporation can have its charter "repealed, annulled, and forfeited" if it does not pay *its* state taxes, Md. Code Ann., Corps. & Ass'ns § 3-503(a)(2) (1999), that remedy does not extend to the failure of the corporation's shareholders to pay *their* personal state taxes. Even if Maryland did penalize an S corporation for its shareholders' tax delinquencies, moreover, a different regulation, as

the court of appeals noted (Pet. App. 8a-9a), makes a government contractor's payment of penalties and fines an unallowable cost. See 48 C.F.R. 31.205-15(a).

2. Petitioner also contends (Pet. 22-23) that, as construed by the court of appeals, the applicable regulation violates equal protection because it treats S corporations differently than traditional corporations. Review of this argument is unwarranted because it was neither raised nor considered below. *Grupo Mexicano de Desarrollo, S.A.* v. *Alliance Bond Fund, Inc.*, 527 U.S. 308, 318 n.3 (1999).

In any event, the premise of petitioner's claim is invalid because there is no unequal treatment. State taxes paid by any corporation, regardless of the corporation's type, are allowable costs to the extent the corporation can demonstrate that it incurred and paid the taxes, and state taxes paid by any corporation's shareholders are not allowable costs. Moreover, even if the purported unequal treatment existed, petitioner has not contended, and could not establish, that such inequality lacks a rational basis. See *FCC* v. *Beach Commc'ns, Inc.*, 508 U.S. 307, 313 (1993) ("In areas of social and economic policy, a statutory classification that neither proceeds along suspect lines nor infringes fundamental constitutional rights must be upheld against equal protection challenge if there is any reasonably conceivable state of facts that could provide a rational basis for the classification.").

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 06-234

IN THE

Supreme Court of the United States

INFORMATION SYSTEMS & NETWORKS CORPORATION,
Petitioner,

v.

UNITED STATES,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

BRIEF OF *AMICUS CURIAE* CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA IN SUPPORT OF PETITIONER

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INTEREST OF THE *AMICUS CURIAE* [1]

The Chamber of Commerce of the United States of America ("the Chamber") is the world's largest federation of business organizations. It represents an underlying membership of more than three million businesses of every size, operating in every sector of the economy and from every geographic region of the country. More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. One of the Chamber's primary missions is to represent the interests of its members by filing *amicus curiae* briefs in cases involving issues of national concern to American business, including small business. This is such a case.

The Chamber is concerned about the federal government's attempts to penalize government contractors—mainly small businesses that have elected to organize in compliance with Subchapter S of the Internal Revenue Code ("S corporations")—by refusing to accept state income taxes paid by an S corporation as an "allowable" cost of federal government contract performance.[2]

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[1] Pursuant to Sup. Ct. R. 37.6, the Chamber of Commerce of the United States of America states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus curiae*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. The parties' letters of consent to the filing of this brief have been filed with the Clerk's office.

[2] An S corporation is a domestic business with no more than 75 shareholders, having one class of stock, in which all shareholders elect that the business be an S corporation. 26 U.S.C. §§ 1361(a), (b), § 1362(a). "C" corporation refers to an ordinary corporation and is defined in § 1361(a)(2) as "a corporation which is not an S corporation." Many of the current requirements and benefits in Subchapter S were adopted as part of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 Subtitle C §§ 1301-1317.

An allowable cost is an expense for which the contractor is eligible for reimbursement by the federal government. State income taxes paid by sole proprietorships and ordinary corporations are allowable costs of performing government contracts. In this case, the Federal Circuit employed a strained interpretation of the Federal Acquisition Regulation ("FAR"), which governs the procurement activities of an enormous spectrum of federal departments and agencies, to render such costs unallowable when they are incurred and paid by S corporations.

The position advocated by the United States directly contravenes its stated policy of assisting small businesses in selling products and services to the federal government. *See* Small Business Act, 15 U.S.C. § 631 ("Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small-business concerns . . ."). Treating state taxes paid by S corporations as unallowable costs would result in an unfair penalty on small businesses that have elected to do business as S corporations, and it would discourage small businesses from contracting with federal agencies. The Chamber not only believes that, as a matter of policy, S corporations should be reimbursed for the same category of costs and expenses, including state income taxes, that are reimbursed to other business entities, but also that a plain reading of the FAR cost principles mandates this result. Supreme Court review is necessary because the Federal Circuit has reached a different, erroneous, and highly detrimental result.[3]

SUMMARY OF ARGUMENT

In reversing the United States Court of Federal Claims, the Federal Circuit's decision below, holding that an S corpo-

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[3] The Chamber also filed an *amicus* brief before the Federal Circuit in support of the contractor's position.

ration's state income tax costs are unallowable costs under the "Taxes" cost principle of the FAR,[4] is based on a misconstruction of the relationship between an S corporation and its shareholder. The court erred by failing to recognize that (i) the state tax liability in question is a tax derived solely from corporate income; (ii) the ultimate responsibility for payment of the tax rests with the corporation, and (iii) the taxes in question were actually paid by the corporation. *See* Petitioner's Appendix ("Pet. App.") 1a-10a. The trial court correctly recognized these factors and further held that the cost principle in question (48 C.F.R. § 31.205-41) makes no distinction between whether state income tax expenditures are incurred by ordinary corporations or S corporations. *See* Pet. App. 11a-30a.

There is no question that a government contractor doing business as either a sole proprietorship or a C corporation would be reimbursed for the cost of its state income taxes on income generated from performing federal government contracts. Thus, on either end of the spectrum of business organizations, such costs are allowable. By disallowing such reimbursement to S corporations, the United States is essentially penalizing small businesses that elect to organize themselves under subchapter S of the Internal Revenue Code ("IRC"). Such disparate treatment is inconsistent with the purpose underlying subchapter S and finds no support in the FAR itself. In addition, by disallowing reimbursement of state income taxes paid by S corporations, the Federal Circuit's holding conflicts with the underlying purpose of the Taxes cost principle, which is to create a level playing field among government contractors located in states with varying degrees of taxation.

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[4] Presumably, businesses organized as partnerships – which, like S corporations, pass through their tax liability to the individual partners – would suffer this same disparate treatment.

There are no other published decisions on this issue. Because of the Federal Circuit's exclusive jurisdiction over claims involving the government's contractual obligations under the FAR, that court's erroneous decision, unless reversed, will impact thousands of small government contractors across the nation. Such circumstances warrant review by the Supreme Court. *See generally*, R. Stern, E. Gressman, S. Shapiro & K. Geller, Supreme Court Practice 264, 265 (8th ed. 2002) (explaining that because of the Federal Circuit's exclusive jurisdiction over claims "involving many of the legal obligations of the United States . . . the issues in this type of litigation . . . can have a special importance that warrants review by the Supreme Court," and that "the decisions of the Federal Circuit . . . alone often settle the law in the absence of Supreme Court review").

ARGUMENT

I. REVIEW SHOULD BE GRANTED BECAUSE THE FEDERAL CIRCUIT'S DISPARATE TREATMENT OF "S" CORPORATIONS CONFLICTS WITH CONGRESSIONAL POLICIES AND INCENTIVES FOR ENCOURAGING SMALL BUSINESSES TO PARTICIPATE IN FEDERAL PROCUREMENT ACTIVITIES

A. Congress Has Required Government Agencies To Maximize Opportunities For Small Businesses To Perform Government Contracts

The Federal Circuit's view, supported by the United States, is that a cost which is reimbursable if it is incurred by an ordinary corporation is not reimbursable if it is incurred by a small business operating as an S corporation. Such disparate treatment significantly harms the ability of small businesses to compete with large corporations for the award of government contracts. In other words, if a small business must absorb a cost that a large business may charge as an expense

under its government contracts, its cost of doing business is going to be higher, and therefore, its ability to compete with the large business is going to be severely hampered.

Such a result is at odds with congressional policies, which recognize that fair competition and the encouragement and development of the capacity of small businesses are "basic not only to the economic well-being but to the security of this Nation." 15 U.S.C. § 631(a). In this regard Congress stated in the Small Business Act:

> It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as possible, the interests of small-business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts or subcontracts for property and services for the Government . . . be placed with small-business enterprises . . . .

Id. In order to achieve that goal, Congress further mandated:

> [I]t is the continuing policy and responsibility of the Federal Government to use all practical means and to take such actions as are necessary, consistent with its needs and obligations and other essential considerations of national policy, to implement and coordinate all Federal department, agency, and instrumentality policies, programs, and activities in order to: foster the economic interests of small businesses; insure a competitive economic climate conducive to the development, growth and expansion of small businesses . . . .

The question in this case has significant financial impact on the thousands of small businesses that provide products and services to government agencies. The United States' view that state income taxes paid by S corporations are unallowable puts those contractors at a disadvantage when competing against larger corporations whose expenditures for

state income taxes are reimbursed and, therefore, contradicts Congress' policy directives.

B. The "Pass-Thru" Provisions Of The Internal Revenue Code Do Not Result In An "Exemption" To A Subchapter S Corporation's State Income Tax Liability

The FAR expressly provides, under the "Taxes" cost principle, that state income taxes are allowable costs. "The following types of costs are allowable . . . Federal, State, and local taxes . . . except as otherwise provided in paragraph (b) of this section that are required to be and are paid or accrued in accordance with generally accepted accounting principles." 48 C.F.R. § 31.205-41(a). Under paragraph (b) of the Taxes cost principle, tax costs are unallowable if the contractor is exempt from paying the taxes. "The following types of costs are not allowable: . . . Taxes from which exemptions are available to the contractor directly, or available to the contractor based on an exemption afforded the Government . . . . The term 'exemption' means freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise." *Id* § 31.205-41(b)(3). The United States argued below that state taxes paid by an S corporation are not an allowable cost because S corporations are "exempt" from paying state income tax, as that term is used in the FAR.

In accepting the United States' position, the Federal Circuit reversed the trial court and misconstrued the term "exempt" in the FAR by failing to consider the context in which the IRC treats the income of an S corporation. As the trial court correctly observed, the manner in which the income of an S corporation is taxed does not render the corporation "free" or "exempt" from such taxes, but rather the S corporation's tax

liability is *transferred* to the corporation's shareholder. Pet. App. 21a. The trial court held:

> Plaintiff, as an S corporation, is not relieved of state tax liability, but is simply required to pass its liability on its corporate income to [the shareholder].

Ibid. The IRC itself refers to this transfer of liability as a "pass-thru." 26 U.S.C. § 1366. Some commentators refer to the pass-thru provision as a "taxation alternative" or "conduit concept," under which the S corporation form of organization is the conduit for taxable income to flow from the corporate level to the shareholders for purposes of reporting the corporate income on the shareholder's personal income tax return. *See, e.g.,* Warren Paul Kean, "After the Facelift, Is Subchapter S Any More Attractive?" 46 La. L. Rev. 87, 91, 93 (Sept. 1985). Under the IRC, corporate income and expense items are passed through and taxed to the shareholders at the corporation's year end. 26 U.S.C. §§ 1367(a), 1368. Accordingly, the shareholder, as a conduit for payment of *the corporation's* state income tax, is taxed on the corporate income whether or not it is actually distributed to the shareholder. *See* Kean, *supra* at 103; *see also* 26 U.S.C. § 1366(a) (shareholder's tax liability is determined by taking into account the shareholder's pro rata share of the corporation's items of income).

The Federal Circuit decision glossed over the "pass-thru" nature of what is in all respects (i) the *corporation's* tax liability, and (ii) a cost incurred in performing government contracts. The decision ignored the fact that the state taxes at issue were actually paid by the S corporation when it reimbursed its sole shareholder for the state taxes she paid on corporate earnings. *See* Pet. App. 14(a) (trial court noted that Petitioner Information Systems & Networks Corp. ("ISN") reimbursed its shareholder for the tax payment in question, as contemplated and allowed by the IRC). The Federal Circuit

apparently overlooked this finding when it erroneously stated that ISN did not incur the costs in question:

> As an S corporation, ISN never paid any state income taxes. Only Ms. Malkani paid state income taxes on dividends paid to her from ISN.

Pet. App. 7a-8a. The United States made the same mischaracterization in concluding that "the state income taxes paid by Ms. Malkani were not allowable costs for ISN." Pet. App. 5a. It is disingenuous to categorize the costs in question as costs paid by the shareholder. ISN did precisely what the IRC contemplated when it passed the tax through to its shareholder and then reimbursed her for the tax. Because the subject costs were actually paid by ISN, the question is whether this particular tax expenditure on ISN's books should be treated any differently from state tax expenditures on the books of a C corporation.[5]

The disparate treatment advocated by the United States would result in a windfall to the contracting government agency because it would avoid reimbursing S corporation contractors for costs that are reimbursed to other government contractors. In that regard, when the IRC "S" provisions are read in conjunction with the FAR Taxes cost principle, the only reasonable conclusion is that state tax costs incurred by the S corporation are allowable. The United States' position reflects a social judgment, not a conclusion grounded in the law. In essence, the United States believes the owner of the S corporation somehow would be advantaged by the reimbursement of her state taxes. There is no social or economic basis for that judgment because state taxes are a

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[5] The question of cost allowability does not turn on whether the tax costs were paid directly to the state by the S corporation or whether the S corporation reimbursed the shareholder for her payment to the state. Regardless of which procedure is used, the tax costs would appear the same on the corporation's books and would be subject to the same degree of government agency auditing as any other incurred cost.

cost of doing business no matter how the business is organized. As such, the costs are indistinguishable from other costs reimbursed by government agencies.

The Federal Circuit stated, in conclusory fashion, that the shareholder "is not the contracting entity." Pet. App. 8a. That is an over-simplification which fails to understand that the very purpose of IRC subchapter S is to recognize the identity of interest of the individuals and the corporation, much as though it were a proprietorship. The trial court correctly observed that while the corporate shareholder and the S corporation are indeed legally distinct entities, their "relationship . . . is an important and intermingled one for state tax purposes." Pet. App. 23a. In this "closely intertwined" relationship, it is the corporate entity which, under many state tax codes, is ultimately responsible for ensuring payment of the taxes on the corporate income. *See* Pet. App. 24a (noting that (i) some states require the S corporation to pay the taxes on behalf of its shareholders or withhold such amounts from shareholder distributions, and (ii) in the event the taxes are not paid, the corporation will be subject to penalty and encumbrance on its ability to do business in the state. Pet. App. 24a-25a.

The Federal Circuit completely ignored the point that the ultimate liability for the tax rests with the S corporation. Instead, it focused entirely on the irrelevant point that any "penalties and encumbrances" that might be incurred by a corporation would themselves be unallowable costs under the FAR. Pet. App. 8a. The issue here is not the allowability of penalties. The relevance of the petitioner's argument regarding the S corporation's potential liability for payment of penalties to the state when the shareholder does not pay state income tax is to demonstrate that the corporation is ultimately responsible for paying the tax itself. Whether a particular state tax code uses the term "corporate tax liabilities," "withholdings" or "shareholder income tax," the fact remains

that state income taxes on S corporation income are statutorily-mandated costs of doing business for S corporations. That fact not only confirms the trial court's conclusion that the tax obligations of the corporations and their shareholders are "intermingled," but also confirms that the costs paid by the S corporation are reasonable and allowable pursuant to the FAR cost principles.

C. Treating The Subject Tax Costs As Allowable Under The FAR Would Be Consistent With The "Tax Neutral" Intent Of Subchapter S

The trial court correctly pinpointed the purpose underlying a small business's decision to incorporate under Subchapter S of the IRC – to carry on its activities in a corporate form but without incurring the "double taxation" that normally is applied to corporate income.

> S corporation status is a tax election designed to make the decision of a small business to incorporate "tax neutral;" i.e., a business will incur the same tax liability on its income whether the owners of the business incorporate or not.

Pet. App. 13a.

This view was reflected more than 50 years ago by President Eisenhower in his budget message to the 83rd Congress:

> Small businesses should be able to operate under whatever form of organization is desirable for their particular circumstances, without incurring unnecessary tax penalties. To secure this result, I recommend that corporations with a small number of active stockholders be given the option to be taxed as partnerships . . . .

Tax Recommendation § 16, Budget Message of January 1953.[6]

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[6] *See also, Klein v. Comm.*, 75 TC 298, 302-03 (1980) (quoting S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958)) ("Congress sought to allow a

When Congress enacted the Subchapter S Revision Act of 1982, its intention was to minimize further the effect of income taxes on choices of the form of business organization by continuing to enable small business to have the benefits of incorporation without the incidence of income taxation at both the corporate and shareholder levels. S. Rep. No. 640, 97th Cong., 2d Sess. 5, *reprinted in* 1982 U.S.C.C.A.N. 3253-57.

Subchapter S exists as a hybrid taxation mechanism in which S corporations are intended to have many of the advantages of both the corporate and partnership forms of operation.[7] The chief advantage is designed to be tax *neutrality* – the avoidance of double income tax on corporate earnings; *i.e.*, a tax applied when the corporation earns the income, and a second tax applied when that income is distributed to the individual shareholder. Thus, if a small business is organized as a partnership (with the partners individually incurring the tax liability on behalf of the business), but the partners wish to take advantage of a corporate structure, they may do so without incurring the tax at both the corporate and individual levels.

Under the Federal Circuit's holding, while the S corporation performing government contracts does not face the prospect of double taxation, it nevertheless faces a severe adverse consequence with respect to its inability to recover the costs of its state tax liability – costs which clearly would be recoverable if the business were organized differently. As noted above, the Federal Circuit held, in part, that the costs in

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small business corporation to be taxed much like a partnership so that 'businesses [can] select the form of business organization desired, without the necessity of taking into account major differences in tax consequence'").

[7] Among the advantages of operating in the corporate form are limited liability, centralization of management, continuity of life, and free transferability of ownership interests. *See* Kean, *supra* at 91.

question were not allowable because the shareholder herself was not the contracting entity. Pet. App. 8a. In that regard, if the contracting entity were simply an individual carrying on a sole proprietorship, there would be no question that the individual's state income tax on earnings from government contracts would be an allowable cost. Likewise, if that individual elected to organize her business as a C corporation, and the C corporation became the contracting entity, there is no question that the C corporation's state income taxes on income from its government contracts would be an allowable cost for reimbursement. Thus, on either end of the spectrum of business organizations, such costs are allowable. But under the United States' view, as accepted by the Federal Circuit, small businesses falling in the middle of the spectrum – those organized as S corporations – are inherently ineligible for this same cost reimbursement benefit.

The trial court correctly held that there is no basis in Subchapter S's pass-thru provisions for denying reimbursement under the FAR for the corporation's state tax expenditures. The trial court could not identify any reason that a business should lose out on such reimbursement solely because of its organization as an S corporation. Pet. App. 21a-22a.

Nor can the United States assert any policy justification under the IRC or the FAR for denying reimbursement. Indeed, to hold that such costs incurred by an S corporation are unallowable would be akin to imposing a penalty on the S corporation purely because of the form of the organization. By rendering the subject costs unallowable for reimbursement under the contract, the United States is, in effect, giving rise to an unintended adverse tax consequence based purely on the form of the business organization. Accordingly, the United States' view that S corporations should be singled out under the FAR cost principle – which otherwise provides reim-

bursement for state tax liability – runs afoul of the purpose behind Subchapter S of the IRC.

II. REVIEW SHOULD BE GRANTED BECAUSE THE FEDERAL CIRCUIT'S OPINION CONFLICTS WITH THE PLAIN LANGUAGE OF THE FAR "TAXES" COST PRINCIPLE THAT RENDERS THE SUBJECT COSTS ALLOWABLE

The trial court correctly held that "[n]othing in the FAR provisions involved in this case points to an intent that certain types of commercial organizations should be denied reimbursement altogether simply because of their tax election or corporate structure." Pet. App. 20a-21a. The Taxes cost principle in the FAR provides that state taxes are allowable if they are "required to be and are paid or accrued in accordance with generally accepted accounting principles." 48 C.F.R. § 31.205-41(a)(1). Thus, "State income taxes in general are allowable costs under the section" (Pet. App. 19a); however the United States' position is that this allowability is available only to contractors organized under other forms, sole proprietorships as well as publicly traded Fortune 500 C corporations.

One of the goals of the FAR is to create a level playing field among businesses seeking to sell goods and services to the federal government. *See, e.g.*, 48 C.F.R. § 1.102-2(c)(3) (one underlying purpose of the FAR is to codify rules which treat all contractors and prospective contractors fairly and impartially); 48 C.F.R. § 19.201(a) ("It is the policy of the Government to provide maximum practicable opportunities in its acquisitions to small business, veteran-owned small business, service-disabled veteran-owned small business, HUBZone small business, small disadvantaged business, and women-owned small business concerns"). The Federal Circuit's interpretation of the Taxes cost principle, disal-

lowing reimbursement of state tax costs to S corporations, skews the field to the extreme ends of the business spectrum.

In addition, the Taxes cost principle is intended to create a level playing field by removing geographic disparities from the competition for government contracts. J. Bedingfield & L. Rosen, Government Contract Accounting (2d ed. 1985), p. 10-31. In that regard, the reimbursement of state income taxes ensures that a contractor doing business in a state with high income taxes will not have to incur greater costs than a contractor located in a state with little or no income taxes. The Federal Circuit's holding is inconsistent with this underlying purpose of the Taxes cost principle.

Because the state tax costs at issue here are, in fact, routinely paid by S corporations (either by reimbursing shareholders or by paying the taxes directly to the state), and because the FAR makes no distinction between the type of business organization that incurs the expense of state taxes, the plain language of the cost principle renders the S corporation's taxes as allowable costs. The United States cannot point to any provision in the FAR which provides for or even hints at disparate treatment for small businesses or S corporations. In interpreting statutes or regulations, courts must look to "the language itself, the specific context in which that language is used, and the broader context of the statute as a whole." *Robinson v. Shell Oil Co.*, 519 U.S. 337 (1997).

The United States argued below that the reason such costs should be unallowable is that the "pass-thru" provision of Subchapter S is the same as an "exemption" from having to pay state taxes, as the term "exemption" is defined in 48 C.F.R. § 31.205-41(b)(3). But there is no authority equating the IRC's "pass-thru" provisions with the FAR's use of the term "exemption." The trial court correctly recognized that the "pass-thru" provision "is not a tax exemption in the normal sense of the term" because the pass-thru does not

result in an "abatement" or the complete absence of the tax liability. Pet. App. 21a.

Indeed, the FAR itself describes the purpose behind making tax expenses unallowable in some circumstances:

> These provisions intend that tax preference attributable to Government contract activity be realized by the Government.

48 C.F.R. § 31.205-41(b)(3). This is a reference to FAR Part 29, which prescribes policies and procedures for government agencies, and in some instances for contractors, to assert immunity or exemption from state and local taxes. *See* 48 C.F.R. § 29.000, § 29.303; *see also* 48 C.F.R. § 31.205-41(a)(1) which references FAR Part 29. In that regard, the "exemption" referred to in the cost principle

> means freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise.

48 C.F.R. § 31.205-41(b)(3).

The trial court correctly found that the S corporation's "transfer of liability" to the shareholder did not result in a tax abatement. Pet. App. 22a.[8] The United States, without support, argued before the Federal Circuit that § 31.205-41(b)(3) (the provision making tax expenses unallowable when the contractor is exempt from taxation) does not re-

[8] The trial court correctly described the distinction between the IRC's provisions for "transferring" tax liability to the S corporation's shareholder and an "abatement" of the tax liability. Pet. App. 21a. In fact, the tax liability arises and is incurred at the corporate level. Pursuant to the IRC provision – which is intended to enable small businesses to avoid adverse tax consequences from organizing as a corporation – the tax liability on the corporate income is passed through to the shareholder, but the taxes are routinely paid or reimbursed in the normal course of business by the corporation.

quire an "abatement" of tax liability because the term "abatement" is only one example of an applicable exemption. Pet. App. 7a.

That assertion ignores the plain meaning of the language preceding the word "abatement" – "freedom from taxation." Those words have a plain meaning and stand for an unremarkable straightforward proposition – if the business incurs no taxation on its income, then costs incurred in paying taxes, which ultimately end up not being owed, are not subject to reimbursement under the FAR. *See* Pet. App. 29a (in which the court noted that the provision is designed to preclude a contractor's double recovery of taxes in the event it receives both a refund from the state and reimbursement under its federal contracts).

The United States' effort to turn this provision into a disallowance of tax expenditures incurred by S corporations finds no support in the text of the cost principle.

III. REVIEW SHOULD BE GRANTED BECAUSE THE SUBJECT COSTS ARE REASONABLE UNDER THE FAR AND ARE THEREFORE ALLOWABLE

Assuming *arguendo* that the Taxes cost principle at 48 C.F.R. § 31.205-41 does not expressly apply to the costs incurred by an S corporation either in reimbursing its shareholders for their payment of state income tax on income generated by the S corporation, or in paying those taxes directly to the state, the costs are still "reasonable" pursuant to the FAR cost principles, and therefore allowable.

The allowability of costs incurred by a government contractor depends principally on the reasonableness of those costs, and whether they are subject to any specific limitations set forth in the FAR cost principles.[9] 48 C.F.R. § 31.201-

[9] "Allocability," the third principal factor in determining allowability, *see* 48 C.F.R. § 31.201-2(a)(2), is not an issue here.

2(a). Pursuant to the FAR, a cost is reasonable, and therefore, in the context of this appeal, allowable, "if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business." 48 C.F.R. § 31.201-3(a). The reasonableness of an incurred cost depends on a variety of factors, including: (i) whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance most notably, and (ii) generally accepted sound business practices, arm's-length bargaining and Federal and State laws and regulations. 48 C.F.R. § 31.201-3(b).

An S corporation's payment of its shareholder's state income tax attributable to income generated by the S corporation is such a reasonable cost. The election to do business as an S corporation is a reasonable business decision. By paying the taxes generated by its income, the S corporation performing government cost reimbursable contracts incurs an expense that does not exceed that which would be incurred by a prudent person in the conduct of competitive business. In this case, an S corporation reasonably paid that part of the state income tax imposed on its shareholder on that portion of her income that was generated by the corporation itself. The fact that the amount of the expense is determined in accordance with state law further suggests the reasonableness of the amounts at issue.

Moreover, it is reasonable for an S corporation to pay the portions of its shareholders' state income taxes that are attributable to income generated by the corporation because – unlike the shareholders of C corporations – an S corporation's shareholders are taxed on the corporation's earnings rather than on the cash that is distributed to them. By the same token, it is also an advantage for a small business to be able to retain earnings to increase its flexibility in paying other expenses, which flexibility would be curtailed if shareholders were to demand cash distributions sufficient to meet their

corporate income related tax liabilities. Accordingly, it is common, and certainly reasonable, for S corporations to enter into agreements to reimburse the shareholder, or pay the tax on the distribution of shareholder's income attributable to the corporation.

With regard to costs that are not specifically addressed by 48 C.F.R. § 31.205, that section

> does not cover every element of cost. Failure to include any item of cost does not imply that it is either allowable or unallowable. The determination of allowability shall be based on the principles and standards in this subpart and the treatment of *similar or related items*.

48 C.F.R. § 31.204(c) (emphasis added). Accordingly, an item of cost that is not specifically addressed by the principles in FAR 31.205 may nonetheless be allowable if it is reasonable (and allocable to the contracts at issue). *Cf. Gould Defense Systems, Inc.*, ASBCA No. 24881, 83-2 BCA ¶ 16,676 (amortization of goodwill recognized as allowable cost, although not specifically addressed by cost standards; recognition that amortization of goodwill and other intangible assets, such as patents, copyrights, leases, licenses and franchises, may be accounted for as incurred costs under GAAP as well).[10]

Assuming that the Court accepts the United States' strained argument that the cost at issue here is not specifically addressed in the FAR's Taxes cost principle, it is certainly

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[10] The United States could challenge the clear and plain language of the Taxes cost principle by proceeding through the regulatory change process, which would include a notice and comment period which would permit a full review of the new anti-small business policy it asks the courts to sustain. For example, the United States' reaction to the *Gould* decision was to promulgate a new cost principle at 48 C.F.R.§ 31.205-49, which makes the amortization, expensing, write-off or write-down of goodwill expressly unallowable. *See BAE Systems Information,* ASBCA No. 44382, 01-2 BCA ¶ 31,495.

"similar or related" to a "selected item," state tax, that is addressed and is allowable. *See* 48 C.F.R. § 31.205-41(a)(1). *Cf. Southwest Marine, Inc.*, ASBCA No. 54234, 2005 WL 467158 (Feb. 23, 2005) (determination of allowability of costs not specifically addressed by FAR cost principles includes analysis of treatment of selected items that are similar or related).

A state tax expense that is reimbursed or directly paid by the S corporation instead of by the shareholder is a type of cost that would generally be recognized as ordinary and necessary for the conduct of an S corporation's business; if it were not, there would be considerably less incentive for a government contractor to do business as an S corporation. Indeed, "[t]he implied promise of Subchapter S is that distributions equal to net corporate income will not result in a 'double' tax." J. Eustice & J. Kuntz, Federal Income Taxation of S Corporations (3d ed. 1993), ¶8.01[1].

It is also eminently reasonable for S corporations to pay the state income taxes of their shareholders on income attributable to the corporations in light of the tax payment or withholding requirements in several states with respect to shareholders who reside outside the taxing state, as noted above. Accordingly, the principles and standards in the FAR render the subject costs reasonable and allowable.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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